Supreme Court, U.S.
FILED

NO. 95 1497 MAR 19 1996

IN THE OFFICE OF THE CLERK

Supreme Court of the United States

OCTOBER TERM, 1995

RICHARD A. and ALICE D. CRAMER,
WARREN K. and SUSI M. BOYNTON, and
KEVIN P. and DINA A. MONAGHAN,
Petitioners,

-against-

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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March 18, 1996

CASILLAS PRESS, INC., 1717 K STREET, N.W., WASHINGTON, D.C. 20036

106 pp

QUESTION PRESENTED

Is a taxpayer's reliance on the advice of competent tax professionals a defense to the penalty for intentional disregard of rules and regulations under I.R.C. § 6653(a), as well as for substantial understatement of tax without reasonable cause under I.R.C. § 6661(a), when, on the basis of the tax professionals' advice, the taxpayer takes a return position that is contrary to a regulation?

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No.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

Petitioners Richard A. and Alice D. Cramer (''Cramer''), Warren K. and Susi M. Boynton (''Boynton'') and Kevin P. and Dina A. Monaghan (''Monaghan'')[1] petition for a writ of certiorari to review a judgment of the United States Court of Appeals for the Ninth Circuit affirming a judgment of the United States Tax Court.

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[1]Petitioners Alice D. Cramer, Susi M. Boynton and Dina A. Monaghan were parties to the proceeding below by virtue of their filing joint income tax returns with their spouses. All references to Cramer, Boynton and Monaghan are to Richard Cramer, Warren Boynton and Kevin Monaghan unless otherwise indicated, and references to Taxpayers are to Cramer, Boynton and Monaghan.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit is reported at *Cramer v. Commissioner*, 64 F.3d 1406 (9th Cir. 1995), and is reprinted at Appendix C, page 3a.[2] The opinion of the United States Tax Court is officially reported at 101 T.C. 225 (1993), and is reprinted at Appendix G.

JURISDICTION

The decision of the Court of Appeals below was entered on September 11, 1995. Taxpayers filed a timely motion to extend the period to file a Petition for Rehearing and Suggestion for Rehearing *En Banc* on September 25, 1995. On December 19, 1995, the Court of Appeals denied the timely Petition of Rehearing relating to the application of Section 83 to the transactions at issue, and on December 22, 1995, the Court denied the timely Petition for Rehearing and Suggestion for Rehearing *En Banc* relating to the application of civil tax penalties to the transactions at issue. (Appendix B, page 2a; Appendix A, page 1a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND RULES

Section[3] 6653: FAILURE TO PAY TAX.

(a) NEGLIGENCE OR INTENTIONAL DISREGARD OF RULES AND REGULATIONS WITH RESPECT TO INCOME, GIFT, OR WINDFALL PROFIT TAXES. —

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[2]All page references of the form "____a" are to the Appendices to this petition.

[3]Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1954 or to regulations promulgated thereunder in effect during the years at issue in this case.

(1) IN GENERAL. — If any part of any underpayment (as defined in subsection (c)(1)) of any tax imposed by subtitle A, by chapter 12 of subtitle B or by chapter 45 (relating to windfall profit tax) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

(2) ADDITIONAL AMOUNT FOR PORTION ATTRIBUTABLE TO NEGLIGENCE, ETC. — There shall be added to the tax (in addition to the amount determined under paragraph (1)) an amount equal to 50 percent of the interest payable under section 6601 —

(A) with respect to the portion of the underpayment described in paragraph (1) which is attributable to the negligence or intentional disregard referred to in paragraph (1), and

(B) for the period beginning on the last date prescribed by law for payment of such underpayment (determined without regard to any extension) and ending on the date of the assessment of the tax. . . .

Section 6661(a): SUBSTANTIAL UNDERSTATEMENT. If there is a substantial understatement of income tax for any taxable year, there shall be added to the tax an amount equal to 25 percent of the amount of any underpayment attributable to such understatement.

Section 83: PROPERTY TRANSFERRED IN CONNECTION WITH PERFORMANCE OF SERVICES.

(a) GENERAL RULE. — If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of —

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property,

shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable . . . .

(b) ELECTION TO INCLUDE IN GROSS INCOME IN YEAR OF TRANSFER. —

(1) IN GENERAL. — Any person who performs services in connection with which property is transferred to any person may elect to include in gross income, for the taxable year in which such property is transferred, the excess of —

(A) the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over

(B) the amount (if any) paid for such property.

If such election is made, subsection (a) shall not apply with respect to the transfer of such property . . .

(c) SPECIAL RULES. — For purposes of this section —

(1) SUBSTANTIAL RISK OF FORFEITURE. — The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.

(2) TRANSFERABILITY OF PROPERTY. — The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture . . . .

(e) APPLICABILITY OF SECTION. — This section shall not apply to —

. . .

(3) the transfer of an option without a readily ascertainable fair market value . . .

Treas. Reg. Sections 1.83-7(b)(1) and (2):

(b) READILY ASCERTAINABLE DEFINED. (1) Actively traded on an established market. Options have a value at the time they are granted, but that value is ordinarily not readily ascertainable unless the option is actively traded on an established market. If an option is actively traded on an established market, the fair market value of such option is readily ascertainable for purposes of this section by applying the rules of valuation set forth in § 20.2031-2.

(2) Not actively traded on an established market. When an option is not actively traded on an established market, it does not have a readily ascertainable fair market value unless its fair market value can otherwise be measured with reasonable accuracy. For purposes of this section, if an option is not actively traded on an established market, the option does not have a readily ascertainable fair market value when granted unless the taxpayer can show that all of the following conditions exist:

(i) The option is transferable by the optionee;

(ii) The option is exercisable immediately in full by the optionee;

(iii) The option or the property subject to the option is not

subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value of the option; and

(iv) The fair market value of the option privilege is readily ascertainable in accordance with paragraph (b)(3) of this section.

STATEMENT OF THE CASE

Preliminary Statement. In 1982, the Taxpayers sold their stock and stock options in IMED Corp. ("IMED") to Warner-Lambert Corporation for cash, realizing a substantial gain. On the advice of competent tax counsel, the Taxpayers reported the income from the sale of the stock options as capital gain. However, the Internal Revenue Service ("IRS") maintained that the amount they received for the stock should have been taxed as ordinary compensation income as property they received in connection with the performance of services under Section 83. In addition to the resulting deficiency in income tax, the IRS also imposed two penalties, one for intentional disregard of an IRS regulation (Treas. Reg. § 1.83-7) and the other for substantial understatement of income tax without reasonable cause. The Tax Court and the Ninth Circuit have upheld the IRS. The issue that the Taxpayers ask to be reviewed is whether despite their reliance on the advice of competent tax professionals about their tax liability, the Taxpayers may nevertheless be liable for the two penalties.

The issue Taxpayers ask this Court to review is neither academic, sterile nor unique. The Taxpayers lived the American Dream only to see it become a tax nightmare. Cramer started IMED and developed commercially the intravenous infusion pump that is used in hospitals in the United States and throughout the world, and in 1982 sold the company

to Warner-Lambert. There is not the slightest doubt that Congress intended to tax entrepreneurs such as Cramer at favorable capital gains rates when they realized the appreciation on their creativity, vision and risk. Nevertheless, the millions of dollars Warner-Lambert paid Cramer, Monaghan and Boynton in 1982 for their IMED stock options have been treated as compensation income. But what has made the sale of the stock options a tax nightmare is the additional cost of the two penalties, which together with interest total $24.7 million.

The Taxpayers' tax nightmare grows out of IMED's use of nonqualified stock options to compensate IMED employees during IMED's difficult start-up and growth period. In 1976, when it changed the tax treatment of stock options, Congress directed the IRS to value difficult-to-value stock options in new ventures (and include the value in income as compensation) if the recipient of the option so elected:

> The conferees intend that in applying these rules for the future, the Service will make every reasonable effort to determine a fair market value for an option (*i.e.*, in cases where similar property would be valued for estate tax purposes) where the employee irrevocably elects to have the option valued at the time it is granted (particularly in the case of an option granted for a new business venture).

S. Rep. No. 1236, 94th Cong., 2d Sess. 439 (1976) ("1976 Conference Report"), *reprinted in* 1976-3 C.B. 843 (vol. 3). A regulation that was in proposed form when Congress spoke in 1976 was adopted in final form in 1978 (Treas. Reg. § 1.183-7), before the sale of the IMED options, and this regulation effectively limited this treatment to publicly-traded options, excluding new ventures such as IMED because their options were not publicly traded. The Taxpayers received ad-

vice from competent tax professionals, however, that they could rely on the 1976 Congressional directive to the IRS, rather than follow the regulation that conflicted with that directive. On the basis of their tax professionals' advice, they filed elections to include the value of the options they received in income with the IRS, which, although they did not know it, the IRS had no way of associating with their returns. Because they believed the options were difficult to value, although they had some value, they included a zero value for the options. After they sold their stock and options to Warner-Lambert, the Taxpayers' accountants again reviewed the tax treatment of the options, and despite the regulation which would have required compensation income treatment, calculated the tax due at capital gains rates because there was in their view reasonable support for that position.

The Tax Court upheld the IRS's determination that the amount realized from the sale of the IMED options was compensation income, that the 1976 Conference Report was nonauthoritative post-enactment legislative history, that Cramer, Monaghan and Boynton had intentionally disregarded Treas. Reg. § 1.83-7 and that they had understated their income tax for 1982 without reasonable cause. The Ninth Circuit affirmed. This petition seeks a writ of certiorari to review the judgment of the Ninth Circuit on the penalty issue.

Consideration by IMED and the Taxpayers of the Tax Consequences of the Grant of IMED Options. IMED granted stock options to the Taxpayers in 1978, 1979 and 1981 (the "IMED Options"). In 1978, when these options were first granted, Dan Hendrickson ("Hendrickson"), a certified public accountant and IMED's controller, researched the tax consequences of the issuance and receipt of the IMED Options. Hendrickson learned that the 1976 Conference Report allowed the recipients

of the IMED Options to elect to include the options' value in income upon receipt. Hendrickson believed the IMED Options could be valued and that their value was zero based on his experience with valuation for gift and estate tax purposes.

Hendrickson confirmed his conclusion with William Rutledge, Jr. ("Rutledge"), a certified public accountant and a tax manager at IMED's accountants, Arthur Young & Co. Rutledge also concluded that the IMED Options could have readily ascertainable fair market value even if they were not publicly traded, because legislative history said that restricted options to purchase stock in start-up companies have a readily ascertainable fair market value. Rutledge agreed that if an election were filed to include the value of the IMED Options in income, gain on the later sale would be treated as capital gain. Hendrickson and Rutledge each independently researched whether the Taxpayers could make Section 83(b) elections for the IMED Options, reviewing the Code, tax regulations, legislative history and commentators. Hendrickson and Rutledge studied the 1976 committee reports and concluded that the intent of Congress was that the IMED Options could have readily ascertainable value even though the proposed regulations under Section 83 provided no mechanism for valuing the IMED Options.

Hendrickson also discussed the tax treatment of the IMED Options with Robert Douglas ("Douglas"), a partner at the accounting firm of Jassoy, Graf & Douglas ("Jassoy, Graf"). Jassoy, Graf also provided accounting services to IMED. Douglas and Hendrickson discussed the requirement under Section 83(b) that the taxpayer determine a fair market value for options received. Douglas reviewed the 1976 Conference Report and concluded that the statute permitted valuation of options to buy stock of closely-held companies such as IMED.

IMED's tax advisors, including Hendrickson and Douglas, conveyed their conclusions to Cramer, Boynton, and Monaghan. Hendrickson explained to Cramer that the IMED Options were covered by Section 83, and certain filings were required in order to obtain capital gain treatment on their sale.

Cramer was not knowledgeable in the tax area but he understood from his conversations with Hendrickson and Monaghan that the legislative history of Section 83 authorized a Section 83(b) election for options to purchase stock in a start-up company such as IMED because Congress had recognized the need to assist entrepreneurs. Cramer discussed with Rutledge, Monaghan and Hendrickson the possibility that the IRS might take a contrary position. Boynton was also told about the decision to file Section 83(b) elections when IMED Options were issued.

Based on these discussions, it was decided that IMED would have standard procedures for every IMED employee who received options to purchase IMED stock. A Section 83(b) election would be filed by each recipient. Monaghan would provide Hendrickson with a list of employees who received the IMED options, and Hendrickson would prepare the Section 83(b) election forms for filing. The Section 83(b) election forms Hendrickson prepared contained: (1) a heading which read "Election In Accordance with Reg. 1.83-2(e), Sec. 83(b);" (2) the optionee's name, address and social security number; (3) a description of the property subject to the option, including the number of shares covered by the option; (4) the date of the property's transfer; (5) the restrictions stated in the option; (6) the fair market value of the option; (7) the amount paid for the option; (8) a statement that copies had been provided to the optionor as required by Treas. Reg. §

1.83-2(d); and (9) the signature and date of signature.[4]

The Sale to Warner-Lambert. IMED grew rapidly from 1972, when it was founded, to 1978, when the IMED Options were first granted, to 1982, when IMED was sold. At the end of 1981, the management of the Warner-Lambert Corporation ("Warner-Lambert") approached the officers and directors of IMED and offered to acquire the outstanding shares of IMED. In August, 1982, Warner-Lambert and IMED entered into an agreement under which Warner-Lambert purchased all outstanding vested and non-vested options to acquire IMED stock. The sales price for each IMED Option held by the Taxpayers was the difference between $163.81 and the exercise price stated in the particular option agreement. As part of the agreement, the former officers and directors of IMED, including Cramer, Boynton and Monaghan, resigned as of the date of Warner-Lambert's acquisition.

The Reporting of the Sale of the IMED Options in 1982. The Taxpayers reported the 1982 sale of their IMED stock and IMED Options on their 1982 federal income tax returns.[5] The Taxpayers each looked to his tax advisor for assurance that the position being taken on the return with regard to the IMED Options was correct. Cramer's return was prepared by Robert Jassoy ("Jassoy"), a certified public accountant and a partner at Jassoy, Graf. Cramer asked Jassoy to review the proper tax treatment of the IMED Options to determine if the analysis of Hendrickson and Rutledge was more likely than

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[4]Based on advice of counsel, for reasons not relevant here, an election was not filed for Cramer's 1979 option. In addition, the Taxpayers did not file elections for the 1981 options because the options were received in the form of trust interests. The court below treated the transaction as if the Taxpayers had received the options directly.

[5]Cramer's 1982 federal income tax return accurately reported the gain on the sale of the IMED Options, but incorrectly reported the basis of the IMED Options.

not correct. Jassoy ultimately concluded that Cramer had a more than reasonable position for claiming long-term capital gain treatment on the sale of the IMED Options. Jassoy made his determination based on facts given to him by Cramer and based on discussions with Douglas, Hendrickson and Monaghan. Monaghan's 1982 return was also prepared by Jassoy. Boynton's 1982 tax return was prepared by Charles Wieseler ("Wieseler"), a certified public accountant who had been preparing Boynton's returns since 1970. Boynton discussed the tax treatment of the sale of the IMED options with Wieseler. Monaghan spoke with Wieseler and informed him that based on the advice of the other tax professionals, the sale of the IMED options should get capital gain treatment, but Wieseler did not do an independent review of the issue. Boynton also relied on Hendrickson and Monaghan for the position taken on his tax return.

Jassoy and Douglas discussed Douglas's opinion of the appropriateness of the Section 83(b) elections filed with regard to the IMED Options and the basis for his opinion. Jassoy and Douglas also discussed the Tax Court's decision in *Alves v. Commissioner*, 79 T.C. 864 (1982), *aff'd*, 734 F.2d 478 (9th Cir. 1984). Douglas felt that *Alves* strengthened IMED's position with regard to the proper treatment of the IMED Options. Douglas recognized that there was a risk that the IRS would treat the fair market value of the IMED Options as compensation income rather than as long-term capital gain, but he believed that it was appropriate to treat the sale of IMED Options as giving rise to capital gain. Jassoy also concluded that the gain on the sale of the IMED Options was capital gain.

The Tax Court upheld the IRS's determination that the amount realized from the sale of the IMED options was compensation income, that the Congressional directive was non-authoritative post-enactment legislative history, that Cramer,

Monaghan and Boynton had intentionally disregarded Treas. Reg. § 1.83-7 and that they had understated their income tax for 1982 without reasonable cause.

The Ninth Circuit Opinion. The Ninth Circuit, affirming the Tax Court, held that under Section 83(e)(3) and Treas. Reg. § 1.83-7(b)(2), the IMED options did not have a readily ascertainable fair market value at the time of transfer to the Taxpayers. Accordingly, the Ninth Circuit held that notwithstanding Cramer, Boynton and Monaghan's filing of elections under Section 83(b), the gain on the sale was taxable entirely as ordinary income in 1982.

In addition, the Ninth Circuit affirmed the Tax Court's decision to uphold penalties on Cramer, Boynton and Monaghan for intentionally disregarding rules and regulations and substantially understating their income tax. The Ninth Circuit concluded that there was no "reasonable basis" defense to the penalty for intentionally disregarding rules or regulations, even though the regulation was contrary to the 1976 Conference Report. Although the Ninth Circuit admitted that the Taxpayers relied on their accountants' and lawyers' advice that the 1976 Conference Report justified treating gain on the sale of options as capital gain, the court held that the Taxpayers did not have reasonable cause and good faith for purposes of the penalty for substantial understatement of income tax.

After a panel of the Ninth Circuit filed its opinion affirming the Tax Court's decision, Cramer, Monaghan and Boynton filed a Petition for Rehearing and a Suggestion for Rehearing *En Banc*. The Petition and Suggestion pointed out that the Ninth Circuit panel was failing to consider that its conclusion regarding the intentional disregard penalty was contrary to this Court's decision about what constitutes taxpayer "ordinary business care and prudence," conflicted with decisions in other circuits, and that the court had misread the Second Circuit's

opinion in *Druker v. Commissioner*, 697 F.2d 46 (2d Cir. 1982), *cert. denied*, 461 U.S. 957 (1983), regarding the intentional disregard penalty. The Petition and Suggestion were denied.

This petition seeks a writ of certiorari to review the judgment of the Ninth Circuit on the penalty issues.

REASONS FOR GRANTING THE WRIT

Certiorari should be granted in this case to establish a clear standard of taxpayer conduct to ensure that in thousands of penalty cases that arise each year, taxpayers have been given fair warning about what constitutes reasonable conduct, to make certain the IRS asserts penalties only in appropriate cases and to assist courts in reviewing disputes between taxpayers and the IRS over penalty issues. In *Cramer*, the Taxpayers consulted competent tax professionals about the tax consequences of receiving non-publicly traded stock options in their medical appliance company. Based on that advice, competent tax professionals prepared the Taxpayers' tax returns reporting the transaction. Although the Taxpayers consulted the tax professionals and relied on their advice about their tax liability, the Ninth Circuit upheld penalties and interest on penalties against them totaling $24.7 million. Finding that the tax advisors' position was erroneous, the Ninth Circuit held that the Taxpayers were liable for a penalty for intentionally disregarding a regulation about the tax treatment of non-publicly traded options, and also a 25 percent penalty for substantially understating their income without reasonable cause. The Taxpayers in fact did know about the regulation because the tax advisors told them about it, but they also advised them they could take a contrary position on their tax returns. The tax advisors said the Taxpayers could take the position because there was support for it in legislative history specifically addressing the treatment of non-publicly traded stock options.

In upholding intentional disregard and substantial understatement penalties, the Ninth Circuit adopted a standard of taxpayer conduct. Under that standard, a taxpayer's consultation with competent tax advisors and reliance on those advisors will not constitute a reasonable basis for disregarding an interpretive regulation or reasonable cause for understating income tax. Moreover, if the taxpayer's tax professional makes an error in the return, that error will be attributable to the taxpayer in a determination about whether the taxpayer's conduct was reasonable.

1. The Ninth Circuit's rejection of the Taxpayers' reliance on tax professionals creates uncertainty about whether and under what circumstances taxpayers will be able to avoid civil penalties when they consult with and rely on the advice of tax professionals, but the professionals' advice is found to be erroneous. This is an issue of substantial importance in the administration of the tax laws in general and the civil penalty provisions of the Internal Revenue Code in particular. From 1976 to 1994, Congress amended the Internal Revenue Code a total of 177 times. At the same time, Congress added new civil penalties to the Code without coordinating them with the existing penalties. For example, the substantial understatement penalty upheld by the Ninth Circut in this case was added to the Code in 1982, without coordination with the negligence or intentional disregard penalty the Taxpayers were also found liable for. As a result, the Taxpayers owe both penalties for essentially the same conduct. Although in 1989, Congress amended the Code to insure that Taxpayers were not subject to more than one penalty for the same act of misconduct, the IRS annually imposes thousands of civil penalties for noncompliance with the tax laws. In fiscal 1992, for example, the IRS imposed almost 1.2 million negligence penalties against individuals amounting to $425 million. Internal Revenue Service, 1992 Annual Report, p. 42. In fiscal 1985, the IRS also

assessed 1,660 substantial understatement penalties. By fiscal 1988, the number of assessments had increased 2,292 percent to 39,700. During this period, the dollar value of the substantial understatement penalties increased by 5,850 percent, from $2 million to $119 million. GAO Report "Negligence and Substantial Understatement Penalties Poorly Administered," GAO/GGD 91-90 at p. 9.

The Ninth Circuit held that the Taxpayers could not avoid the penalty for intentional disregard of a regulation by claiming that they had "a reasonable basis" for doing so because they relied on the advice of their tax professionals in taking a position contrary to the regulation. This holding conflicts with this Court's description of the standard of taxpayer conduct in civil penalty cases. In *Boyle*, the Court dealt with the question of whether an executrix could rely on an attorney to avoid the delinquency penalty for willfully neglecting the filing date of an estate tax return, and concluded that a taxpayer could not avoid the delinquency penalty when the tax obligation was a well-known filing date. *United States v. Boyle*, 469 U.S. 241 (1985). But in *Boyle*, the Court also articulated a standard of taxpayer conduct in determining the amount of the taxpayer's tax liability, saying that "[w]hen an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice." *Boyle* at 251. When the Taxpayers' tax professionals advised them about the tax consequences of their receipt and subsequent sale of their options, therefore, under *Boyle*, they acted reasonably. Yet in *Cramer*, the Ninth Circuit held, despite the Taxpayers' reliance, that the Taxpayers ignored the regulation intentionally and recklessly, and acted unreasonably in understating income tax.

Accordingly, the opinion of the Ninth Circuit creates an entirely different standard from *Boyle*. If the Ninth Circuit's

opinion stands, it will lead to the anomalous result that a taxpayer who acts reasonably in consulting an accountant or attorney and relies on the professional's advice, and so is free from personal fault in taking a position on his tax return (*Boyle*), can nevertheless be held liable for penalties when the advice turns out to be mistaken.

Moreover, in holding that the Taxpayers were obligated to follow a regulation rather than legislative history even though the Taxpayers' advisors advised them they could rely on the legislative history, the Ninth Circuit adopted a standard of conduct that requires taxpayers to challenge the tax professional they consult. But this Court observed in *Boyle*, "To require the taxpayer to challenge the attorney, to seek a 'second opinion' or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking advice of a presumed expert in the first place. 'Ordinary business care and prudence' do not demand such actions." *Boyle, supra*, at 251 (citation omitted.) Consequently, the Ninth Circuit's standard conflicts with *Boyle* in this respect as well.

Not only does the Ninth Circuit's rejection of the Taxpayers' reliance on the advice of counsel conflict with the standard of taxpayer conduct this Court established in *Boyle*, it also creates a disagreement with decisions of other circuits. For example, citing *Boyle*, the Fifth Circuit has held that the taxpayers there were not liable for a negligence penalty for claiming a loss on a transaction found to be a sham because they consulted a tax expert who advised them that there was "a good faith, supportable position," for claiming the loss. *Chamberlain v. Commissioner*, 66 F.3d 729, 733 (5th Cir. 1995); *see also Durrett v. Commissioner*, 71 F.3d 515, 518 (5th Cir. 1996) ("Good faith reliance on professional advice concerning the tax laws is a defense [to a negligence penalty]"). The Sixth Circuit, citing the Fifth Circuit *Chamberlain*

opinion, has likewise held that "good faith reliance on professional advice is a defense (to the negligence penalty)." *Gill v. Commissioner*, 1996 U.S. App. LEXIS 3445, *13 (6th Cir. Jan. 23, 1996).[6]

Other circuits have expressed the standard of taxpayer conduct in different terms, and the Ninth Circuit's *Cramer* standard creates confusion with these circuits' standards. For example, the First Circuit has held that a taxpayer is not liable for negligence penalties, if there is "reasonable reliance on expert opinion, asserted in good faith . . ." *McMurray v. Commissioner*, 985 F.2d 36, 43 (1st Cir. 1993). The Tenth Circuit has held that a taxpayer had reasonable cause and was not liable for the substantial understatement of income tax penalty when he "acted in good faith under [the] circumstances in relying on his independent advisors." *Mauerman v. Commissioner*, 22 F.3d 1001, 1006 (10th Cir. 1994) The Second Circuit has added an additional requirement, that the reliance of a taxpayer must be "objectively" reasonable. *Goldman v. Commissioner*, 39 F.3d 402, 407 (2nd Cir. 1994) ("reliance on professional advice can, in certain circumstances, provide a defense to a negligence penalty . . . such reliance must be objectively reasonable.").

The Tax Court has stated yet another standard. Under the Tax Court approach, a taxpayer will not be liable for the negligence penalty "where there has been *bona fide* reliance on

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[6]The Ninth Circuit has itself acknowledged that "good faith reliance on professional advice concerning tax laws is a defense." *Howard v. Commissioner*, 931 F.2d 578, 582 (9th Cir. 1991); *Betson v. Commissioner*, 802 F.2d 365, 372 (9th Cir. 1986) (while hiring an attorney or accountant does not insulate the taxpayer from negligence penalties, "good faith reliance on professional advice is a defense." *Cramer* draws into question whether and under what circumstances a reliance defense still exists in the Ninth Circuit. In *Cramer* when these authorities were argued and brought to the attention of the entire court, the Suggestion for Rehearing *En Banc* was denied.

professional advice even though that advice turned out to be erroneous, particularly in light of the complex [DISC] provisions of the Internal Revenue Code." *Sim-Air USA, Ltd. v. Commissioner,* 98 T.C. 187, 198 (1992).

If civil penalties are to be fairly administered, there should be a clear standard of taxpayer conduct. The Ninth Circuit's *Cramer* opinion creates uncertainty about whether the standard of conduct is the one articulated in *Boyle,* the one in the variations of *Boyle* described by the various circuits, the one used by the Tax Court or the one adopted by the Ninth Circuit in *Cramer.* The Court should grant certiorari to establish a clear standard applicable in all courts, to educate taxpayers to their responsibilities in tax matters, and to guide the IRS in the administration of the tax laws.

2. Unless the Court clarifies the applicable standard of taxpayer conduct, even if taxpayers consult with tax professionals, taxpayers will be subject to intentional disregard and substantial understatement penalties if they rely on their advisors for return positions that are contrary to published IRS positions, even if those positions are only the IRS's interpretation of the law, not the law itself. In rejecting the Taxpayers' argument that they should not be subject to the penalty for intentionally disregarding rules or regulations, the Ninth Circuit relied primarily on the Second Circuit's opinion in *Druker v. Commissioner,* 697 F.2d 46 (2d. Cir. 1982), *cert. denied,* 461 U.S. 957 (1983). *Cramer* at 1414. *Druker* involved an Assistant U.S. Attorney and his wife who used rate schedules applicable only to unmarried persons to challenge on Constitutional grounds the so-called marriage penalty on taxpayers paying tax at the rates for married taxpayers unambiguously set forth in Section 1 of the Code, and rules and regulations promulgated under the unambiguous Code provision. The Second Circuit held that the taxpayers were liable for the intentional disregard penalty

because "*they intentionally violated Section 1 of the Code and the rules and regulations promulgated thereunder.*" In reversing the Tax Court on this issue, the Second Circuit said,

> [The Drukers' position] is not that a "rule or regulation does not accurately reflect the Code", but rather that Section 1 of the Code is inconsistent with the Constitution . . .. *[A] taxpayer who has intentionally disregarded a rule or regulation can not claim the benefit of [a reasonable basis] exemption where, as here, his dispute is with Congress rather than the IRS.*

Druker at 53-56 (citations omitted, footnotes omitted and emphasis added).

The Ninth Circuit's reliance on *Druker* creates confusion, however, because *Druker* itself acknowledges that there are situations where a taxpayer's taking a position that is arguably contrary to the regulations will not result in the imposition of penalties for "intentionally" disregarding rules or regulations. Thus the Second Circuit said:

> Departure from the natural and ordinary meaning of the words, whose literal application does not result in any manifestly absurd or unfair result, *could be justified only if there were other evidence that the overall purpose of Congress would be better served by such a reading.*

Druker at 53 (emphasis added). The Ninth Circuit fails to acknowledge the exception provided above in *Druker* and reads out of the penalty any means for a taxpayer to avoid its imposition, regardless of the taxpayer's reasonable reliance on counsel that itself is following a clear Congressional directive. When the taxpayer fails to follow a regulation or revenue ruling, therefore, the Ninth Circuit's rejection of any reliance

defense creates confusion about whether a taxpayer may ever avoid the intentional disregard penalty.

The Ninth Circuit's decision in *Cramer* also conflicts with the Tax Court's interpretation of *Druker*. The Tax Court has interpreted *Druker* to mean that there is no intentional disregard of rules and regulations if the applicable statute or regulation "contravenes the intent of Congress."[7] *Washburn v. Commissioner*, 61 T.C.M. (CCH) 2529, 2532 (1991), *aff'd without op.*, 992 F.2d 321 (2d Cir.), *cert. denied*, 114 S. Ct. 186 (1993). The Tax Court has also held that a taxpayer's reliance on the advice of professionals to help ascertain the intent of Congress is evidence that the taxpayer did not intentionally disregard rules and regulations. *Hill v. Commissioner*, 63 T.C. 225, 251 (1974), *aff'd without op. sub. nom., Tenner v. Commissioner*, 551 F.2d 313 (9th Cir. 1977) (reliance on accountants and lawyers led court to conclude that it was "unable to hold that petitioners were guilty of an intentional disregard of rules and regulations"). Adding to the confusion, on another occasion, the Tax Court has stated that it "will leave to another day the applicability of Section 6653(a) [intentional disregard penalty] where the taxpayer has a reasonable basis for his position in light of *Druker*." *Grant v. Commissioner*, 84 T.C. 809, 826 n.28 (1985), *aff'd without op.* 800 F.2d 260 (4th Cir. 1986).

Accordingly, there is disagreement and confusion in the circuit courts and the Tax Court about whether a taxpayer can

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[7]Prior to *Druker*, the Fifth Circuit also concluded that the intentional disregard penalty may be avoided by the "taxpayer showing that he had no intent to disregard rules or regulations or by excusing his action with an acceptable and justifiable reason, such as have been accepted by courts in the past." *Marcello v. Commissioner*, 380 F.2d 499, 506 n.20 (5th Cir. 1967). In fact, Treasury itself has previously stated that there was a reasonable basis exception to the intentional disregard penalty. Treas. Reg. 1.6694-1(a)(4).

ever avoid the penalty for intentionally disregarding a regulaton even if the taxpayer has consulted with a tax professional and has taken a position that is believed by counsel to be consistent with the intent of Congress, but that is contrary to a regulation. The Ninth Circuit's decision elevates a regulation or other IRS pronouncement to "law," a knowing violation of which will also subject the taxpayer to a substantial penalty. This Court should resolve this disagreement and confusion so that the IRS does not inappropriately penalize taxpayers or at the very least that taxpayers are given a clear warning about what conduct will subject them to civil penalties.

3. The *Cramer* decision creates confusion about a taxpayer's responsibility if the taxpayer relies on a tax professional who makes an error in the preparation of the tax return. The Ninth Circuit said that the Taxpayers acted without reasonable cause and so were subject to penalty because errors their tax returns "appear[ed] designed to avoid audit" and Taxpayers made the "decision to ignore Reg. § 1.83-7(b)(2)." *Cramer* at 1414-15. The Ninth Circuit thus attributed the preparer's error to the Taxpayers and used the attributed error in finding that the Taxpayers did not act with reasonable cause. As this Court has said, "what elements must be present to constitute 'reasonable cause' is a question of law." *Boyle* at 249 n.8. Under *Boyle*, when the Taxpayers consulted and relied on their tax professionals regarding their tax liability, they acted reasonably and prudently, and therefore as a matter of law could not have intentionally disregarded rules and regulations. By failing to follow the elements of reasonable cause described in *Boyle*, therefore, the Ninth Circuit has created confusion about when a taxpayer who relies on a competent tax return preparer acts with reasonable cause.

That the Ninth Circuit applied an erroneous "reasonable cause" standard is shown by the circuit court's treatment of the evidence in the case. Thus, the Ninth Circuit concluded

that computational errors Cramer's accountants made on his 1982 tax return are evidence of bad faith and "appear designed to avoid audit." *Cramer* at 1415. There was literally no evidence that the Taxpayers engaged in a conspiracy with their accountants to mislead or conceal the circumstances of the sale of the options from the IRS by making mistakes in the reporting of the sale on their 1982 tax returns. As the record evidence showed, the errors on the return were made by the preparers of the returns, not by the Taxpayers. One of the return preparers testified that the IMED option sale was reported on a schedule entitled "Stocks and Bonds" to distinguish it from the investment transactions in puts and calls made after the sale. Cramer's return preparers reported the correct gain on the sale of the options. The error the Ninth Circuit said appeared to avoid audit was in reporting the stock options as having a basis when they in fact had a zero basis, but this error was offset by an error in the amount realized so that the amount of the gain on the sale of the options was correctly reported. The error occurred because the accountant preparing the return used a schedule provided by IMED that correctly showed the gross amount realized on the sale of both IMED stock *and* options, not the net amount for the options alone, and the accounting firm failed to catch the basis error in reviewing the return. At any rate, the Taxpayers' returns disclosed sufficient information to apprise the IRS of the transaction. The number of options, the dates acquired and the name of the corporation the return disclosed was sufficient to apprise the IRS that these were the same options for which Section 83(b) elections had been filed. *See Wesley Heat Treating Co. v. Commissioner*, 30 T.C. 10, 26 (1958), aff'd, 267 F.2d 853 (7th Cir. 1959) (sufficient information disclosed in returns to apprise the Commissioner of the nature of the deductions).

In short, by attributing the accountants' error to the Taxpayers, the Ninth Circuit has adopted a standard of conduct which penalizes taxpayers even when they use competent professionals. Congress has provided specific penalties for certain tax return preparer errors that are applied to return preparers, supporting the position that a return preparer's errors should not be attributed to a taxpayer. See I.R.C. § 6694. Contrary to the Ninth Circuit's view, moreover, the Tax Court has held that an accountant's factual errors in preparing a tax return should not be attributed to a taxpayer for purposes of determining whether a taxpayer has acted with ordinary business care. *See Bellour v. Commissioner*, 69 T.C.M. (CCH) 3010 (1995). Accordingly, the Court should fashion a standard that will, in this circumstance, guide taxpayers, the IRS and the courts.

CONCLUSION

The petition for a writ of certiorari should be granted.

March 18, 1996

Respectfully submitted,

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APPENDIX A

FILED
DEC 22 1995
CATHY A. CATTERSON
CLERK
U.S. COURT OF APPEALS

NOT FOR PUBLICATION
UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 94-70066
IRS No. 0974-3

RICHARD A. CRAMER; ALICE D. CRAMER;
WARREN K. BOYNTON; SUSI M. BOYNTON;
KEVIN P. MONAGHAN; DINA A. MONAGHAN
Petitioners-Appellants

vs.

COMMISSIONER INTERNAL REVENUE SERVICE
Respondent-Appellee

ORDER

Before: LAY,* BRUNETTI, and RYMER, Circuit Judges.

The panel has voted to deny the petition for rehearing filed on November 15, 1995.

Judges Brunetti and Rymer have voted to reject the suggestion for rehearing en banc. Judge Lay has voted to recommend the rejection of the suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. P. 35(b).

The petition for rehearing is denied and the suggestion for rehearing en banc is rejected.

*Hon. Donald P. Lay, Senior United States Circuit Judge for the Eighth Circuit Court of Appeals, sitting by designation.

APPENDIX B

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DEC 19 1995
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NOT FOR PUBLICATION
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KEVIN P. MONAGHAN; DINA A. MONAGHAN
Petitioners-Appellants

vs.

COMMISSIONER INTERNAL REVENUE SERVICE
Respondent-Appellee

ORDER

Before: LAY,* BRUNETTI, and RYMER, Circuit Judges.

The petition for rehearing filed by appellants Kevin and Dina Monaghan on November 16, 1995, is denied.

*Hon. Donald P. Lay, Senior United States Circuit Judge for the Eighth Circuit Court of Appeals, sitting by designation.

APPENDIX C

Richard A. CRAMER; Alice D. Cramer; Warren K. Boynton; Susi M. Boynton; Kevin P. Monaghan; Dina A. Monaghan,
Petitioners-Appellants,

v.

COMMISSIONER, INTERNAL REVENUE SERVICE,
Respondent-Appellee.

No. 94-70066.

United States Court of Appeals,
Ninth Circuit.

Argued and Submitted July 12, 1995.
Decided Sept. 11, 1995.

Michael I. Saltzman, Baker & McKenzie, New York City, for petitioners-appellants Cramer and Boynton.

Robert K. Smith, Robert F. Dailey, Smith & Dailey, La Jolla, CA, for petitioners-appellants Monaghan.

Gary R. Allen, Gilbert S. Rothenberg, Charles Bricken, United States Department of Justice, Tax Division, Washington, DC, for respondent-appellee.

Appeal from a Decision of the United States Tax Court.

Before: LAY,* BRUNETTI, and RYMER, Circuit Judges.

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*Hon. Donald P. Lay, Senior United States Circuit Judge for the Eighth Circuit Court of Appeals, sitting by designation.

BRUNETTI, Circuit Judge:

Richard and Alice Cramer, Warren and Susi Boynton, and Kevin and Dina Monaghan appeal from a decision of the Tax Court upholding deficiencies and various penalties assessed by the Commissioner of Internal Revenue against their 1982 federal income tax payments. We have jurisdiction pursuant to I.R.C. § 7482(a), and we affirm.

FACTS AND PROCEEDINGS BELOW

In 1972, Richard Cramer founded IMED Corp., a company that designed, manufactured and sold electronic medical instruments. Cramer served as president and chief executive officer of IMED from its inception until 1982. During that time, Warren Boynton served as vice-president, and Kevin Monaghan, an attorney, served as outside general counsel. All three also served at various times on the board of directors of IMED.

From 1978 to 1981, the stock of IMED was neither publicly traded on an established exchange, nor registered with the Securities and Exchange Commission. During that time, that stock was held by approximately 150 to 250 shareholders. In 1978, IMED issued to Cramer an option to purchase, 50,000 shares of IMED stock at $50 per share. The terms of the option provided certain vesting restrictions: Cramer could only exercise the option in 20% increments in each of the next five years and only so long as he remained employed by IMED. The terms also provided certain transfer restrictions: Cramer could only transfer the option to persons approved by the board as "qualified offerees," and any transferee would take the option subject to the vesting restrictions.

In 1979, IMED issued to Cramer an option to purchase 4390 shares of IMED stock at $8 per share, to Boyton an option

to purchase 30,000 shares of IMED stock at $13 per share, and to Monaghan an option to purchase 4500 shares at $13 per share. All of these options provided for a five year vesting schedule and were subject to the same vesting and transfer restrictions as Cramer's 1978 option.

In 1981, on the advice of Monaghan, IMED and Privaco Trust Services S.A., as trustee, entered into a stock option trust agreement. The named beneficiaries included Cramer, Boynton, Monaghan and the other directors of IMED. In 1981, IMED issued to the trustee an option to purchase 325,000 paired shares of IMED stock at various prices. The terms of the option provided that the trustee could not transfer the option except to a beneficiary. Those terms also provided that the option could only be exercised in 1/3 increments in 1983, 1984 and 1985. A separate agreement among the beneficiaries of the trust provided that each beneficiary could be divested of his allocable share of the option if he were no longer employed by IMED on the vesting dates.

IMED issued all of these options in recognition of the services Cramer, Boynton and Monaghan provided to the company. The delayed vesting schedules and restrictions were intended to induce their continued employment with IMED. Appellants never exercised any part of the options.

In 1978, Dan Hendrickson, the corporate comptroller and treasurer of IMED, consulted with an accountant at Arthur Young & Co. regarding the tax treatment of these options. The accountant did not actually review the IMED options. Nonetheless, he informed Hendrickson that as a general matter, I.R.C. § 83(b) elections could be filed to include the value of the so-called "nonstatutory options" (options not subject to I.R.C. § 422), such as the IMED options, in ordinary income at the time of grant, even if they were not publicly traded, and that the options would then receive capital gains treatment upon later disposition.

On the basis of that information, as well as his own research, Hendrickson advised Cramer, Boynton and Monaghan that on the one hand, statements in the legislative history of the 1976 Tax Reform Act arguably supported treating the IMED options in this manner. He told them that in order to have a chance at receiving capital gain treatment upon future disposition of the options, they would have to file § 83(b) elections with the Internal Revenue Service to include their value in ordinary income in the year of the grant. But he told them that on the other hand, under Treasury regulations, he believed that the value of the options could not be readily ascertained upon grant. If that were the case, § 83 would not apply at grant at all. He advised them that pursuant to those regulations, the IRS could take the position that the options would not receive capital gains treatment upon future disposition. He further informed them that acting contrary to or overturning a Treasury regulation "is very difficult."

In an attempt to ensure capital gain treatment upon future disposition of the options, appellants filed § 83(b) elections with the IRS for Cramer's 1978 option, Boynton's 1979 option and Monaghan's 1979 option. The elections stated that the fair market value of the options at the date of grant was zero. No such elections were filed either for Cramer's 1979 option or for the 1981 option issued to the trust. Appellants reported no taxable income in the year of grant from the receipt of any of the options.

Despite filing elections declaring that the options had zero value, Cramer believed that the options had a value greater than zero upon grant. Boynton believed that options had value upon grant, but that it was not "readily recognizable value." Appellants did not consult an expert on options or valuation before they claimed that value as zero.

In 1981, John Stine of Arthur Young began handling IMED's tax matters. At that time, appellants inquired whether the statute of limitations on their treatment of the options would run from the time when they filed the § 83(b) elections. Stine determined that it would not, and also sent a letter to Monaghan stating:

> IMED currently takes the position that its stock options are governed by Section 83 and therefore the present tax treatment is . . . no income to the employee on grant or exercise and no compensation deduction to IMED. However, Regulation 1.83-7 states that an option must have a "readily ascertainable fair market value" before § 83 will apply. Since the definition of "readily ascertainable fair market value" is virtually impossible to meet, IMED's present position is subject to challenge.

He suggested that IMED consider changing its position in light of the potential exposure to exercising employees, should the IRS successfully assert the nonapplication of § 83 at grant. Monaghan discussed Stine's letter with Cramer.

In 1982, Warner-Lambert Corp. purchased all of the stock of IMEd for approximately $163 per share. As part of the agreement, the officers and directors of IMED resigned. Warner-Lambert also agreed to buy all outstanding vested and nonvested options on IMED stock. Warner-Lambert paid appellants approximately $163 less the exercise price for each option. Cramer received $25,945,506 for all of his options; Boynton received $7,714,800 for his options; and Monaghan received $2,273,895 for his.

Tax professionals prepared all of appellants' 1982 federal income tax returns. Those professionals informed appellants that they had a plausible position that gain on the options was capital gain, but that Treasury regulations were to the

contrary. They said that there was a risk the IRS would reach a contrary conclusion.

Richard and Alice Cramer's joint 1982 income tax return reported all but $1.3 million of the receipts from the options as long-term capital gain. The sale of the options was set out in a section of the return designated for stocks and bonds, even though the return contained another section for options. Furthermore, even though Richard Cramer knew they had no basis in the options, the return misreported the options as having a basis of $7,535,620 and sales proceeds of $32,181,126.

Warren and Susi Boynton's joint 1982 income tax return declared all receipts from sale of the options as long-term capital gain. It listed the options as "IMED stock" with a zero basis. Kevin and Dina Monaghan's joint 1982 return also declared all receipts from the sale of the options as long-term capital gain. Even though Kevin Monaghan knew they had no basis in the options, their return misreported the options as having a basis of $2,558,500 and sales proceeds of $4,832,395.

None of the returns disclosed that the options were subject to transfer and vesting restrictions; that § 83(b) elections had been filed with respect to some of the options; that the options were not traded on an established market; or on what authority appellants relied to support their treatment of the options.

The IRS audited appellants' 1982 returns. It determined that the sale of the options produced ordinary income in 1982, not capital gain, and calculated deficiencies accordingly. It also assessed penalties against appellants for intentional disregard of tax rules and regulations, pursuant to I.R.C. § 6653(a) and for substantial understatement of tax, pursuant to I.R.C. § 6661(a).

Appellants challenged these determinations in United States

Tax Court. After a full trial, in a published decision, *Cramer v. Commissioner*, 101 T.C. 225, 1993 WL 369030 (1993), the Tax Court upheld Treas. Reg. § 1.83-7(b)(2) as a valid interpretation of I.R.C. § 83. Under that regulation, because the IMED options were subject to various restrictions at the time of grant, they did not have a "readily ascertainable fair market value" within the meaning of § 83(e)(3). § 83(a) and (b) therefore did not apply to the options at grant, and thus their value was not includable in ordinary income in the year of grant. Accordingly, none of the gain from their subsequent sale in 1982 was taxable as capital gain, and the court upheld the Commissioner's determination of deficiency. The court also found that appellants had intentionally disregarded Reg. § 1.83-7(b)(2), and therefore upheld the penalty assessed pursuant to § 6653(a). It also found that appellants had substantially understated their tax, that they had no substantial authority to support their tax treatment of the options, that they had not disclosed the facts relevant to that treatment on their returns, and that they had not acted in good faith. On those grounds, it upheld the penalty assessed pursuant to § 6661(a). The Cramers, Boyntons and Monaghans timely appeal.

DISCUSSION

I. The Deficiencies in Appellants' 1982 Tax Payments

This case requires us to analyze I.R.C. § 83. That section provides:

> **Property transferred in connection with performance of services**
>
> > **(a) General Rule.** — If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of —

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property,

shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable . . . .

(b) Election to include in gross income in year of transfer.—

(1) In general. — Any person who performs services in connection with which property is transferred to any person may elect to include in gross income, for the taxable year in which such property is transferred, the excess of —

(A) the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over

(B) the amount (if any) paid for such property.

If such election is made, subsection (a) shall not apply with respect to the transfer of such property . . .

(c) **Special Rules.** — For purposes of this section—

(1) **Substantial risk of forfeiture.**— The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.

(2) **Transferability of property.** — The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture . . . .

(e) **Applicability of section.** — This section shall not apply to —

* * * * * *

(3) the transfer of an option without a readily ascertainable fair market value . . . .

A. The 1978 and 1979 Options

Appellants argue that under § 83(e)(3), the 1978 and 1979 IMED options had a "readily ascertainable fair market value" at the time of transfer, and that therefore § 83 applied to the transfer of those options. They filed § 83(b) elections with the IRS to include the value of the 1978 Cramer option and the 1979 Boynton and Monaghan options in ordinary income in

the year of the transfer.[1] While they no longer maintain that those options had zero value upon grant, they argue that, pursuant to § 83(b), the value of those options (determined without regard to any restrictions) was taxable as ordinary income in the year of transfer, and that any subsequent appreciation in value was taxable as capital gain upon sale in 1982. *See* Boris I. Bittker & Martin J. McMahon, Jr., *Federal Income Taxation of Individuals* ¶ 37.4, at 37-24 (1988).

The Commissioner argues that those options did not have a "readily ascertainable fair market value" at the time of transfer, and that therefore, under § 83(e)(3), § 83 did not apply at the time of transfer. According to this analysis, the transfer of the options was a nontaxable event, § 83 applied only when appellants sold the options in 1982, *see* Treas.Reg. § 1.83-7(a), and the proceeds were taxable entirely as ordinary income. *See id.;* I.R.C. § 83(a).

Thus, the issue presented by this case is whether, at the time of the original transfer, the options had a "readily ascertainable fair market value," within the meaning of I.R.C. § 83(e)(3). Treasury has issued a regulation defining this standard. That regulation provides that an option that is not traded on an established market, such as the IMED options,

> does not have a readily ascertainable fair market value when granted unless the taxpayer can show that *all* of the following conditions exist:

---

[1]Cramer did not file a § 83(b) election with respect to his 1979 option, and therefore cannot argue that its value was taxable as ordinary income in 1979 pursuant to that subsection. Nor has he argued to us that its value was taxable as ordinary income in any year prior to 1982 pursuant to § 83(a). Regardless of any such argument that he could have made, for the reasons described below, we conclude that § 83 did not apply to that option until its sale in 1982.

> (i)The option is transferable by the optionee;
>
> (ii) The option is exercisable immediately in full by the optionee;
>
> (iii)The option or the property subject to the option is not subject to any restriction or condition . . . which has a significant effect upon the fair market value on the option; and
>
> (iv) The fair market value of the option privilege is readily ascertainable in accordance with paragraph (b)(3) of this section.

Treas.Reg. § 1.83-7(b)(2) (emphasis added).

[1] The 1978 and 1979 IMED options clearly did not meet all four of these conditions at the time of transfer, and therefore did not have a "readily ascertainable fair market value" according to this regulation. Because the options could not be exercised unless the original recipient remained employed at IMED, the options were subject to "substantial risk of forfeiture." *See* I.R.C. § 83(c)(1). The terms of the options also required that if they were transferred, the transferee must take the options subject to this risk. Thus, the options were not "transferable" within the meaning of the statute. *See* I.R.C. § 83(c)(2). Moreover, the five year vesting schedule rendered them not "exercisable immediately in full" upon grant. Finally, appellants do not seriously challenge the Tax Court's factual finding that the transfer and vesting restrictions had a "significant effect upon the fair market value on the option[s]." We need not address whether the fourth condition was satisfied, because, even though appellants presented evidence below that the value of each IMED "option privilege" was ascertainable, these options so clearly failed the first three conditions. Therefore, according to Reg. § 1.83 -7(b)(2), the value of the options was not readily ascertainable at the time of

transfer, § 83 did not apply to that transfer, and the gain from the 1982 sale of those options was ordinary income, not capital gain.

Rather than contest this analysis, appellants argue that Reg. § 1.83-7(b)(2) is simply an invalid interpretation of I.R.C. § 83. They point out that § 83(a) and (b) both require that all lapsing restrictions, such as those listed in Reg. § 1.83-7(b)(2)(i-iii), be disregarded when valuing an option for purposes of calculating the tax. They argue that such restrictions should also be disregarded when determining whether an option has a "readily ascertainable fair market value" within the meaning of § 83(e)(3). Since, rather than disregarding those restrictions, Reg. § 1.83-7(b)(2) mandates that such restrictions prevent an option from satisfying the § 83(e)(3) test, appellants argue it is invalid.

[2] The Tax Court determined that the regulation was valid. That decision depended upon the court's interpretation of the Internal Revenue Code, which we review de novo. *Williamson v. Commissioner*, 974 F.2d 1525, 1529 (9th Cir.1992). However, we will uphold a Treasury regulation if it "implement[s] the congressional mandate in some reasonable manner," *National Muffler Dealer's Ass'n. v. United States*, 440 U.S. 472, 476, 99 S.Ct. 1304, 1306, 59 L.Ed.2d 519 (1979), and is not "plainly inconsistent" with the Code. *Bingler v. Johnson*, 394 U.S. 741, 750-51, 89 S.Ct. 1439, 1445, 22 L.Ed.2d 695 (1969).

[3,4] We conclude that Reg. § 1.83-7(b)(2) is neither plainly inconsistent with, nor an unreasonable interpretation of, § 83. The plain meaning of the statute supports Treasury's interpretation. § 83(a) and (b) both contain language requiring that the value of transferred property be "determined without regard to any restriction . . . ." This language is conspicuously absent from § 83(e)(3). Adoption of appellants' argument

would require us to read that language into § 83(e)(3). It is a fundamental rule of statutory construction that "[w]hen Congress includes a specific term in one section of a statute but omits it in another section of the same Act, it should not be implied where it is excluded." *Arizona Elec. Power Co-op., Inc. v. United States*, 816 F.2d 1366, 1375 (9th Cir.1987) (citing *Russelo v. United States*, 464 U.S. 16, 23, 104 S.Ct. 296, 300, 78 L.Ed.2d 17 (1983)).

Furthermore, Congress has had opportunity to include such language in § 83(e)(3), or otherwise to amend the statute in order to insure that § 83 applies to options subject to restrictions, but it has failed to do so. Reg. § 1.83-7(b)(2), which became effective in 1978, adopted the definition of "readily ascertainable fair market value" contained in Treas.Reg. §1.421-6(c)(3)(i), which became effective in 1961. When Congress enacted § 83 in 1969, it was aware of Treasury's definition of that standard. *See Pagel, Inc. v. Commissioner*, 91 T.C. 200, 216, 1988 WL 81469 (1988), *aff'd*, 905 F.2d 1190, 1192 (8th Cir. 1990) (concluding that Reg. § 1.83-7(b)(2) is a valid interpretation of the statute). Nonetheless, when Congress included this standard in § 83(e)(3), it did not indicate that restrictions should be disregarded for purposes of that subsection.

Since the enactment of § 83, Congress has passed the Tax Reform Act of 1976, which applied § 83 to "statutory" options previously controlled by I.R.C. § 422. The Senate Finance Committee version of the 1976 bill included an amendment to § 83 that would have allowed taxpayers to elect to include the value of an option in income in the year of grant, even if its fair market value was not readily ascertainable. S.Rep. No. 938, 94th Cong., 2d Sess. 164 (1976), U.S.C.C.A.N.1976, pp. 2897, 3596, *reprinted in*, 1976-3 Internal Revenue Cumulative Bulletin [C.B.] (vol.3) 49, 202. This proposal would

have insured that § 83 applied upon grant to restricted options as well as to other difficult to value options. It was not enacted. Therefore, since Congress has failed to require that § 83 applies to restricted options upon grant, we will not do so by implication.

Appellants cite legislative history from the 1976 Tax Reform Act to argue that Reg. § 1.83-7(b)(2), which had only been proposed at that time, is invalid. The 1976 Conference Report explaining that Act states:

> The conferees intend that in applying these rules for the future, the Service will make every reasonable effort to determine a fair market value for an option (i.e., in cases where similar property would be valued for estate tax purposes) where the employee irrevocably elects (by reporting the option as income on his tax return or in some other manner to be specified in regulations) to have the option valued at the time it is granted (particularly in the case of an option granted for a new business venture). The conferees intend that the Service will promulgate regulations and rulings setting forth as specifically as possible the criteria which will be weighed in valuing an option which the employee elects to value at the time it is granted.

S.Rep. No. 1236, 94th Cong., 2d Sess. 438-39 (1976), *reprinted in* 1976-3 C.B. (vol.3) 807, 842-43. *See also* Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, 94th Cong., 2d Sess. 154 (1976), *reprinted in* 1976-3 C.V. (vol.2) 1, 166 (containing virtually identical language).

This legislative history does not demonstrate that the Reg. § 1.83-7(b)(2) interpretation of § 83 is unreasonable. First,

"an analysis of legislative history is proper only to *solve*, not to *create* ambiguity." *Arizona Elec. Power,* 816 F.2d at 1375 (emphasis in original). As we explained above, the language of § 83 itself ably describes under which subsections restrictions must be disregarded — § 83(a) and (b). This legislative history, on the other hand, provides at best an ambiguous directive regarding § 83(e)(3): It is unclear whether the conferees intended that the Commissioner should henceforth disregard the restrictions listed in then-proposed Reg. § 1.83-7(b)(2)(i-iii), or whether she should relax the rules on valuing the "option privilege" proposed in Reg. § 1.83-7(b)(3), or neither. *See* 2 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts,* ¶ 60.5.2 at 60-51 (2nd ed. 1990). Second, the 1976 Tax Reform Act in no way amended the language of § 83, which was enacted in 1969. We hesitate to rely entirely on the views of a later Congress to interpret an earlier enactment. *See United States v. Price,* 361 U.S. 304, 313, 80 S.Ct. 326, 331-32, 4 L.Ed.2d 334 (1960). Finally, this statement may well have been inserted to assuage members who could not pass the 1976 amendment contained in the Senate Finance Committee bill and discussed above. *See Pagel,* 91 T.C. at 221. It at most invited, but did not require Treasury to adopt rules that Congress did not enact. *Id.*

[5] Treasury reasonably concluded that § 83(e)(3) allows restrictions to be considered when determining whether an option has a "readily ascertainable fair market value." Furthermore, Treasury reasonably concluded that certain restrictions, such as those effecting transfer, exercise, and market value, make an option's value not "readily ascertainable," because it is difficult to determine the impact of those restrictions on market value. We therefore reject appellants challenge to Reg. § 1.83-7(b)(2).

In sum, because the 1978 and 1979 options clearly did not

have a "readily ascertainable fair market value" upon transfer according to Reg. § 1.83-7, § 83 did not apply until the sale of those options in 1982, *see* I.R.C. § 83(e)(3); Reg. § 1.83-7(a), and that sale therefore produced only ordinary income. We affirm the Tax Court's decision upholding the deficiency with respect to these options.

B. The 1981 Option Held by the Trust

Appellants did not file § 83(b) elections to include the value of the 1981 option in ordinary income in the year of grant. However, they argue that the value of that option was includable in ordinary income in the year of grant pursuant to § 83(a), because it was not subject to a substantial risk of forfeiture. They argue it was not subject to that risk because only the separate agreement among beneficiaries, not the actual terms of the options, provided that each appellant could be divested of his allocable share of the option if he left the employ of IMED. They argue that this separate agreement does not affect the tax treatment of the 1981 option.

[6] We need not address this argument. Rather, we conclude that regardless of whether the separate agreement among beneficiaries affects the tax treatment of the 1981 option, § 83(a) did not apply to that option until its sale in 1982. The actual terms of that option, as opposed to the agreement among beneficiaries, provided that it could only be exercised in increments in 1983, 1984 and 1985. Therefore, it was not immediately exercisable, and condition (ii) of Reg. § 1.83-7(b)(2) was not satisfied. Accordingly, that option lacked a "readily ascertainable fair market value," § 83 did not apply until sale in 1982, *see* I.R.C. § 83(e)(3); Reg. § 1.83-7(a), and that sale produced only ordinary income. We affirm the Tax Court's decision upholding the deficiency with respect to this option.

II. The Penalty Under I.R.C. § 6653(a) for Intentional Disregard of Rules and Regulations

The version of I.R.C. § 6653(a) applicable to appellants provides: "If any part of any underpayment . . . is due to negligence or intentional disregard of rules and regulations . . . there shall be added to the tax . . ." various penalties. We have established that "[i]ntentional disregard occurs when a taxpayer who knows or should know of a rule or regulation chooses to ignore its requirements." *Hansen v. Commissioner*, 820 F.2d 1464, 1469 (9th Cir.1987).

In this case, the Tax Court found that appellants learned from their various tax advisors that capital gain treatment of the 1982 options sale was contrary to Reg. § 1.83-7(b)(2). Nonetheless, appellants, together with their advisors, concluded that there was a plausible argument that the regulation was invalid. On the basis of that argument, they decided to claim capital gain treatment on their returns. Under these circumstances, the Tax Court upheld the penalties assessed pursuant to § 6653(a).

[7] We review that decision for clear error. *See Hansen*, 820 F.2d at 1469. Appellants bear the burden of proving that § 6653(a) did not apply. *Id.* Appellants do not challenge the Tax Court's basic finding of fact. Rather, they argue that because they had a reasonable basis to believe that the regulation was invalid, and because they were so advised by tax professionals, they should not be subject to the penalty.

The Second Circuit has rejected such a "reasonable basis" exception to § 6653(a). *Druker v. Commissioner*, 697 F.2d 46, 53-55 (2d Cir.1982), *cert. denied*, 461 U.S. 957, 103 S.Ct. 2429, 77 L.Ed.2d 1316 (1983). After exhaustively tracing the legislative history of the statute as well as the relevant caselaw, that court stated:

> The statutory language "there shall be added", could hardly be clearer. The reasonableness of a taxpayer's action may indeed be relevant when he is charged with negligence but not when he admittedly has flouted applicable rules and regulations which he fully understood.

Id. at 53. That court went on to describe favorably a Board of Tax Appeals case: " '[h]arsh though the conclusion may seem', the 5 percent addition was mandatory even where the taxpayer had reasonably believed, on the advice of counsel, that a regulation issued by the Commissioner was invalid." *Id.* at 54 (citing *The Journal Co. v. Commissioner,* 46 B.T.A. 841, 845-46, 1942 WL 270 (1942), *rev'd on other grounds,* 134 F.2d 165 (7th Cir.1943)).

[8] We too reject appellants' "reasonable basis" argument. Appellants are sophisticated businessmen, one of whom is himself an attorney. After carefully reviewing the matter with their tax advisers, they decided to ignore Reg. § 1.83-7(b)(2), because they thought it invalid. As the court in *Druker* explained, the proper course, by which they would have avoided the risk of penalty, was to file their returns in accordance with the regulation, and then to challenge the validity of the regulation in a suit for a refund. *See* 697 F.2d at 54. Instead, appellants chose to play the audit lottery. They lost. The Tax Court did not clearly err by upholding their penalty pursuant to §6653(a).

III. The Penalty Under I.R.C. § 6661(a) for Substantial Understatement of Tax.

The version of the Code that applies to appellants' 1982 returns provides: "If there is a substantial understatement of income tax for any taxable year, there shall be added to the tax an amount equal to 25 percent of the amount of any

underpayment attributable to such understatement." I.R.C. § 6661(a) (1986). It is undisputed that the deficiencies that we have affirmed in Section I of this opinion were "substantial understatements" of tax as defined by § 6661(b). Nonetheless, the statute provides that the amount of an understatement shall be reduced by the portion of the understatement which is attributable either, 1) to tax treatment that was supported by "substantial authority," or, 2) to tax treatment about which the relevant facts were "adequately disclosed in the return or in a statement attached to the return." I.R.C. § 6661(b)(2)(B). Futhermore, the Commissioner may waive any such penalty on a showing by the taxpayer that there was reasonable cause for the understatement and that the taxpayer acted in good faith. I.R.C. § 6661(c).

[9, 10] The Tax Court concluded that appellants' tax treatment of the options was not supported by substantial authority. We review this conclusion of law de novo. *See Norgaard v. Commissioner*, 939 F.2d 874, 878 (9th Cir.1991). "Substantial authority" supports a position "only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary positions." Treas. Reg. § 1.6661-3(b)(1). Appellants' treatment of the options does not meet this test. They have relied heavily upon ambiguous legislative history from 1976 Tax Reform Act that was created subsequent to the enactment of § 83. The principle authorities supporting the contrary position include the plain meaning of the statute, and a regulation promulgated by Treasury interpreting that statute. These authorities far outweigh those cited by appellants. The Tax Court properly refused to reduce appellants' penalties pursuant to the substantial authority exception.

[11] The Tax Court also found that appellants did not adequately disclose the facts relevant to their tax treatment of the options. We review this finding of fact for clear error.

See Fed.R.Civ.P. 52(a). Appellants do not even challenge the Tax Court's finding that rather than disclosing the relevant facts, their 1982 returns actually concealed the true nature of the option proceeds. Cramer and Monaghan both claimed basis in the options, even though they knew they had none. Also, Cramer and Boynton both listed the options in sections labeled for stock, even though the returns contained separate sections for options. These unexplained misrepresentations appear designed to avoid audit. Furthermore, we reject appellants' argument that their filing of § 83(b) elections in 1978 and 1979 provided adequate disclosure. § 6661(b)(2)(B)(ii) explicitly requires that the disclosure be attached to the return itself. Therefore, the Tax Court properly refused to reduce appellants' penalties pursuant to the disclosure exception.

The Tax Court also found that appellants did not act in good faith. We review this finding of fact for clear error. *See* Fed. R.Civ.P. 52(a). The concealment described in the previous paragraph, coupled with appellants' decision to ignore Reg. § 1.83-7(b)(2), amply supports this finding. Therefore, the Tax Court correctly concluded that the good faith/reasonable cause waiver did not apply in this case.

Accordingly, we affirm the Tax Court's decision to uphold the entire penalty for substantial understatement of tax.

CONCLUSION

The Tax Court correctly upheld the deficiencies assessed by the Commissioner against appellants' 1982 tax payments. The Tax Court also correctly upheld penalties assessed by the Commissioner against appellants because they disregarded the relevant regulations and substantially understated their tax.

AFFIRMED.

APPENDIX D

UNITED STATES TAX COURT

Docket No. 27682-90

RICHARD A. CRAMER and ALICE D. CRAMER,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE
Respondent.

DECISION

Pursuant to the opinion of the Court filed September 22, 1993, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioners for the calendar year 1982 in the amount of $7,802,334.00;

That pursuant to the provisions of I.R.C. § 6653(a)(1), there is an addition to tax due from the petitioners for the year 1982 in the amount of $390,117.00;

That pursuant to the provisions of I.R.C. § 6653(a)(2), there is an addition to tax due from the petitioners for the year 1982 in an amount equal to 50% of the interest which has accrued on the amount of $7,393,652.00; and

That pursuant to the provisions of I.R.C. § 6661(a), there is an addition to tax due from the petitioners for the year 1982 in the amount of $1,848,413.00.

(Signed) Mary Ann Cohen
Judge.

Entered: NOV 17 1993

The parties stipulate that the foregoing decision is in accordance with the opinion of the Court and that the Court may enter the foregoing decision in the above entitled case without prejudice to the right of either party to contest the correctness of the decision entered herein.

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Acting Chief Counsel
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/s/ Robert K. Smith
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Date: Nov. 10, 1993

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Date: Nov. 12, 1993

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Date: Nov. 10, 1993

APPENDIX E

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

Docket No. 27684-90

WARREN K. AND SUSI M. BOYNTON,
Petitioners,

V.

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

DECISION

Pursuant to the determination of the Court as set forth in its Opinion (101 T.C. No. 16) filed September 22, 1993, it is hereby

ORDERED and DECIDED: That there is a deficiency in income tax due from petitioners for the taxable year 1982 in the amount of $2,314,440.

That there is an addition to tax due from petitioners for the taxable year 1982, under the provisions of I.R.C. section 6653(a)(1), in the amount of $115,722.

That there is an addition to tax due from petitioners for the taxable year 1982, under the provisions of section 6653(a)(2), in an amount equal to 50 percent of the interest due on $2,314,440.

That there is an addition to tax due from petitioners for the taxable year 1982, under the provisions of section 6661, in the amount of $578,610.

/s/ Mary Ann Cohen

Mary Ann Cohen
Judge

Entered: NOV 17 1993

APPENDIX F

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

Docket No. 29100-90

KEVIN P. AND DINA E. MONAGHAN,
Petitioners,

V.

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

DECISION

Pursuant to the determination of the Court as set forth in its Opinion (101 T.C. No. 16) filed September 22, 1993, it is hereby

ORDERED and DECIDED: That there are deficiencies in income tax due from petitioners for the taxable years 1979 and 1982 in the amounts of $4,147 and $619,317.

That there is an addition to tax due from petitioners for the taxable year 1982, under the provisions of I.R.C. section 6653(a)(1), in the amount of $30,966.

That there is an addition to tax due from petitioners for the taxable year 1982, under the provisions of section 6653(a)(2), in an amount equal to 50 percent of the interest due on $619,317.

That there is an addition to tax due from petitioners for the taxable year 1982, under the provisions of section 6661, in the amount of $154,829.

/s/ Mary Ann Cohen

Mary Ann Cohen
Judge

Entered: NOV 17 1993

APPENDIX G

RICHARD A. AND ALICE D. CRAMER, ET AL.,[1]
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE
RESPONDENT

Docket Nos. 27682-90, 27684-90, 29100-90
Filed September 22, 1993.

Ps controlled corporation I. In 1978, 1979, and 1981, I issued options, containing restrictions on vesting and transfer, to Ps, in connection with their performance of services for I. The 1981 options were contributed to a trust. For certain of the options, Ps filed "I.R.C. sec. 83(b) elections", in which elections Ps reported the fair market value of the options as zero. Upon the sale of the options to an unrelated company in 1982, Ps reported the sales proceeds as gains from the sale of capital assets, misdescribing the transactions on their returns. R determined that the sale of the options resulted in ordinary income to Ps for 1982. C, a petitioner, failed to report $1.3 million of the option proceeds in income for 1982.

1. *Held*, the "immediately exercisable" requirement of sec. 1.83-7(b)(2)(ii), Income Tax Regs., is valid. *Held, further*, because the options did not have "readily ascertainable fair market values" as defined in sec. 1.83-7, Income Tax Regs., when they were

[1]Cases of the following petitioners are consolidated herewith: Warren K. and Susi M. Boynton, docket No. 27684-90; and Kevin P. and Dina E. Monaghan, docket No. 29100-90.

granted, the proceeds from such options were taxable as ordinary income at the time of disposition. *Held, further,* the trust formed to hold the 1981 options is disregarded.

2. *Held, further,* the $1.3 million was taxable to C.

3. *Held, further,* additions to tax under secs. 6653(a) and 6661, I.R.C., sustained.

William P. Shannahan, Robert K. Smith, Robert F. Dailey, Seth Throop Karpinski, and *Brookes D. Billman, Jr.,* for petitioners in all cases.

Michael Ira Saltzman, for petitioners in docket Nos. 27682-90 and 27684-90.

William H. Quealy, Jr., Alice M. Harbutte, Thomas A. Dombrowski, and *Valerie N. Larson,* for respondent.

COHEN, *Judge:* In these consolidated cases, respondent determined deficiencies in and additions to petitioners' Federal income taxes as follows:

Richard A. and Alice D. Cramer
Docket No. 27682-90

		Additions to tax		
Year	*Deficiency*	*Sec. 6653(a)(1)*	*Sec. 6653(a)(2)*	*Sec. 6661*
1982	$7,802,334	$390,117	[1]	$1,950,584

[1]50 percent of the interest due on $7,802,334.

Warren K. and Susi M. Boynton
Docket No. 27684-90

		Additions to tax		
Year	*Deficiency*	*Sec. 6653(a)(1)*	*Sec. 6653(a)(2)*	*Sec. 6661*
1982	$2,314,440	$115,722	[1]	$578,610

[1]50 percent of the interest due on $2,314,440.

Kevin P. and Dina E. Monaghan
Docket No. 29100-90

		Additions to tax		
Year	*Deficiency*	*Sec. 6653(a)(1)*	*Sec. 6653(a)(2)*	*Sec. 6661*
1979	$4,147	. . .	. . .	. . .
1982	619,317	$30,966	[1]	$154,829

[1]50 percent of the interest due on $619,317.

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

The issues presented for decision are:

(1) Whether proceeds received by petitioners in 1982 from the sale of certain options granted in 1978, 1979, and 1981 constituted ordinary income or long-term capital gains;

(2) whether Richard A. and Alice D. Cramer (the Cramers) are entitled to exclude $1.3 million of the proceeds received by them from the sale of such options from their income for 1982;

(3) whether petitioners are liable for additions to tax under section 6653(a) for 1982 for underpayments resulting from characterizing the proceeds from the sale of such options as long-term capital gains instead of as ordinary income;

(4) whether petitioners are liable for additions to tax under section 6661 for 1982; and

(5) whether additions to tax under section 6653(a) may be cumulatively assessed with additions to tax under section 6661.

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulated facts are incorporated in our findings by this reference.

At the time of the filing of the petitions, petitioners resided in California.

Petitioner Richard A. Cramer (Cramer) founded IMED Corp. (IMED), a company engaged in the design, manufacture, and sale of electronic medical instruments, primarily a device known as an "infusion pump" and related disposable devices. From 1972 through August 1982, Cramer was a shareholder, the president, and chief executive officer of IMED.

From 1972 through August 1982, petitioner Warren K. Boynton (Boynton) was vice president of IMED. Boynton was on the board from 1972 through October 1973 and from December 1974 through August 1982.

Petitioner Kevin P. Monaghan (Monaghan) served as outside general counsel to IMED from its inception in 1972 until August 1982. From August 1975 through August 1982, Monaghan was assistant secretary of the board of directors of IMED (the board). Monaghan, an attorney admitted to practice in California, was a member of the firm of Hahn, Cazier & Leff from 1979 through 1982. Petitioners Cramer, Boynton, and Monaghan were close friends as well as business associates.

From 1978 through 1981, the stock of IMED was neither publicly traded on an established stock market exchange nor registered with the Securities and Exchange Commission. As of July 7, 1978, there were 571,045 issued and outstanding shares of IMED common stock and 10,000 issued and outstanding voting shares of IMED preferred stock. On

September 26, 1978, IMED effected a 3-for-1 stock split (the stock split) of its outstanding common and preferred stock. As of October 18, 1979, there were 2,061,884 issued and outstanding shares of IMED common stock. According to the shareholder lists of IMED, from 1978 to 1981, the stock of IMED was held by no less than approximately 150 shareholders and no more than approximately 255 shareholders.

On September 26, 1977, the board authorized the grant to Cramer of an option (the Cramer 1978 option) for the purchase of 50,000 shares of IMED common stock at $50 per share.

On May 24, 1978, IMED filed a permit application, prepared by Monaghan, with the California Department of Corporations (the department of corporations) with respect to the proposed issuance of the Cramer 1978 option. In the application, IMED represented that the option contained "special vesting provisions under which the option 'vests' in Mr. Cramer at the rate of 20% (10,000 shares) per year, so that it is not fully vested for five years, with the vesting subject to termination in the event that Mr. Cramer voluntarily resigns as an officer of Applicant." In a letter dated June 7, 1978, to the department of corporations regarding the above application, Monaghan represented that the proposed option contained a 5-year vesting provision. In a letter dated June 19, 1978, Monaghan represented to the department of corporations regarding the Cramer 1978 option that "there is *no* benefit to the optionee in the event the option does not vest. Vesting occurs as a function of time and continued employment."

A notice of annual meeting of shareholders, dated June 14, 1978, that was sent to the shareholders of IMED stated that one of the purposes of the July 7, 1978, shareholders meeting was to authorize the issuance to Cramer of the Cramer 1978 option. A proxy solicitation dated June 14, 1978, was sent to

the IMED shareholders in connection with the July 7, 1978, shareholders meeting soliciting votes in favor of the issuance of the Cramer 1978 option. The proxy statement stated that the board had approved a special stock option to be issued to Cramer "In recognition of the foregoing and other services rendered to the Company by Mr. Cramer, and as an incentive for Mr. Cramer's continued involvement with the Company." It further represented that "The option would 'vest' in Mr. Cramer at the rate of 20% (10,000 shares) per year for five years, so long as he had not voluntarily resigned as an officer of the Company prior to the end of each such 'vesting' year."

The Cramer 1978 option was delivered to Cramer on or about September 1, 1978. The Cramer 1978 option was increased to 150,000 shares as a result of the stock split.

The Cramer 1978 option stated: "Cramer may exercise this Option in 20% increments through the fifth year-end anniversary hereof, so long as he is, at such anniversary date, still an employee of IMED." The Cramer 1978 option contained the following vesting schedule:

Percentage of shares underlying the option that may be exercised	*Earliest date upon which Cramer may exercise*	*Last date upon which Cramer may exercise*
20%	June 30, 1979	June 30, 1988
40	June 30, 1980	June 30, 1988
60	June 30, 1981	June 30, 1988
80	June 30, 1982	June 30, 1988
100	June 30, 1983	June 30, 1988

The option stated that "The intent of the vesting provisions and restrictions * * * is to provide an inducement to Cramer to remain as an employee of IMED for a period of five years and to not voluntarily resign within that period." The Cramer

1978 option also provided that its tranferability was subject to the vesting provisions and limited the persons to whom Cramer could transfer or assign all or a portion of the option to persons approved by the board as "qualified offerees". The approval of the board was stated to be contingent on the receipt of a favorable opinion of counsel and could be refused if the transfer would require registration under section 5 of the Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. sec. 77a (1988).

Cramer was also granted an option dated August 30, 1979, to purchase 4,390 shares of IMED common stock at $8 per share (the Cramer 1979 option). The Cramer 1979 option, like the Cramer 1978 option, provided that the optionee could execise the option "in 20% increments through the fifth year-end anniversary hereof, so long as he is, at such anniversary date, still an employee or consultant to IMED". The Cramer 1979 option contained the following vesting schedule:

Percentage of shares underlying the option that may be exercised	*Earliest date upon which options may exercise*	*Last date upon which optionee may exercise*
20%	Dec. 31, 1979	Dec. 31, 1985
40	Dec. 31, 1980	Dec. 31, 1985
60	Dec. 31, 1981	Dec. 31, 1985
80	Dec. 31, 1982	Dec. 31, 1985
100	Dec. 31, 1983	Dec. 31, 1985

The Cramer 1979 option contained the same transfer restrictions as the Cramer 1978 option.

Boynton was granted an option dated August 17, 1979, for the purchase of 30,000 shares of IMED stock at $13 per share (the Boynton 1979 option). The Boynton 1979 option contained

the same vesting provision as the Cramer 1979 option and the following vesting schedule:

Percentage of shares underlying the option that may be exercised	*Earliest date upon which optionee may exercise*	*Last date upon which optionee may exercise*
20%	Dec. 31, 1979	June 30, 1984
40	Dec. 31, 1980	June 30, 1984
60	Dec. 31, 1981	June 30, 1984
80	Dec. 31, 1982	June 30, 1984
100	Dec. 31, 1983	June 30, 1984

The Boynton 1979 option contained the same transfer restrictions as the Cramer 1978 option.

Monaghan was granted an option dated August 17, 1979, for the purchase of 4,500 shares of IMED common stock at $13 per share (the Monaghan 1979 option). The Monaghan 1979 option contained the same vesting restrictions as the Cramer and Boynton 1979 options and the following vesting schedule:

Percentage of shares underlying the option that may be exercised	*Earliest date upon which optionee may exercise*	*Last date upon which optionee may exercise*
20%	Dec. 31, 1979	June 30, 1984
40	Dec. 31, 1980	June 30, 1984
60	Dec. 31, 1981	June 30, 1984
80	Dec. 31, 1982	June 30, 1984
100	Dec. 31, 1983	June 30, 1984

The Monaghan 1979 option contained the same transfer restrictions as the Cramer 1978 option.

On the advice of Monaghan, a stock option trust agreement (the trust agreement), prepared by Monaghan and dated as of May 29, 1981, was executed by Cramer for IMED and for IMED International Corp. (International) and by a representative of Privaco Trust Services S.A., as trustee. The beneficiaries named in the trust agreement included Cramer, Boynton, Monaghan, and the other directors of IMED.

An option to purchase paired shares of IMED Corp. and IMED International Corp. (option to purchase paired shares), prepared by Monaghan and dated June 1, 1981, for 325,000 paired shares of common stock in IMED and International (225,000 at $100 per paired share and 100,000 at $200 per paired share) was granted to the trustee (the 1981 options). The 1981 options were contributed to the trust created under the trust agreement. The 1981 options were allocated to petitioners as follows:

Name	*Number of paired shares*	*Exercise price*
Cramer	50,000	$100
	100,000	200
Boynton	50,000	100
Monaghan	25,000	100

The 1981 options that were granted on behalf of Cramer, Boynton, and Monaghan will be referred to as the Cramer 1981-100 option (exercise price of $100), the Cramer 1981-200 option (exercise price of $200), the Boynton 1981 option, and the Monaghan 1981 option.

The 1981 options were the only asset of the trust. The sole responsibility of the trustee was to hold the 1981 options and exercise them when directed to do so by Societe Auxiliaire de Financement S.A., an agent of Cramer, Boynton, and

Monaghan. The option to purchase paired shares provided that the trustee could not transfer the 1981 options except to a beneficiary. The trust agreement stated that all of the named beneficiaries had entered into an agreement entitled "Agreement Among Beneficiaries" that set forth "certain conditions under which all or a portion of their allocable share of the stock option may be cancelled".

An agreement among beneficiaries dated as of May 29, 1981, was executed by Cramer, Boynton, Monaghan, and the other beneficiaries of the trust agreement. The agreement among beneficiaries provided that the 1981 options were subject to vesting provisions "designed to assure that each Beneficiary will remain a director or officer of, or a consultant to, IMED or International for a specified period". According to the option to purchase paired shares and the agreement among beneficiaries, the vesting schedule for the 1981 options was as follows: The 1981 options could not be exercised at all until July 31, 1983; they could not be exercised in full until July 31, 1985; and they could not be exercised during the interim period unless, at the time of exercise, the beneficiary was vested as to the portion of the option exercised on his behalf. Each beneficiary was to be deemed vested as to one-third of the number of shares of the 1981 options allocated to him for each full year of service as a director or officer of, or a consultant to, IMED or International commencing as of July 31, 1983. The agreement further provided that each of the beneficiaries could be divested of "some or all of his allocable share of the Option" if his status were to be voluntarily or involuntarily terminated.

The 1978, 1979, and 1981 options (collectively the IMED options) were drafted by Monaghan and were granted to petitioners in connection with the performance of personal services for IMED. None of the IMED options were traded on any registered exchange. None of the IMED options were ever exercised by petitioners.

Dan R. Hendrickson (Hendrickson) was hired as a corporate controller of IMED on March 8, 1976, and became treasurer of IMED on February 14, 1978. In 1978, Hendrickson consulted with William Kimbrough Rutledge, Jr. (Rutledge), an accountant with Arthur Young & Co. (Arthur Young) assigned to the IMED account, regarding the tax treatment of IMED stock options. Rutledge researched and conveyed his conclusion to Hendrickson that elections could be filed under section 83(b) for "nonstatutory options" to include such options in income at the time of grant and receive capital gains treatment upon later disposition of the options. Rutledge did not review any of the IMED options before rendering this advice.

Hendrickson advised Cramer, Boynton, and Monaghan that, in order to have a chance of getting capital gain treatment upon disposition of the options, they should file elections with the Internal Revenue Service (IRS) under section 83(b) and take the value of the IMED options into income at the time of grant. Hendrickson also communicated to Cramer, Boynton, and Monaghan that he did not believe that the value of the options could be readily ascertained and that therefore, under the Treasury regulations, the IRS could take a position adverse to petitioners' treatment of the income from the options as long-term capital gains. Hendrickson further informed petitioners that acting contrary to or overturning a regulation "is very difficult".

In an attempt to ensure capital gain treatment upon disposition of the IMED options, petitioners filed with the IRS "section 83(b) elections" with respect to the grants of the Cramer 1978 option, the Boynton 1979 option, and the Monaghan 1979 option. The elections each stated that the fair market value of each option at the date of grant was zero. The elections were not filed with respect to the Cramer 1979 option or the 1981 options. Petitioners reported no taxable income with

respect to the grants of IMED options on their tax returns for the years in which the options were granted.

Cramer believed that the options had a value greater than zero at the time the options were granted and when he filed his section 83(b) election. Boynton believed that the options had value but did not have a "readily recognizable value" at the time they were granted and at the time he filed his section 83(b) election. No experts on options or valuation of options were consulted in determining that the options had no value.

Monaghan, Hendrickson, and Rutledge failed to keep any written notes or memoranda regarding their research, or supporting petitioners' positions, with respect to section 83 and the IMED options. Petitioners did not attempt to obtain a written opinion from anyone regarding tax treatment of the IMED options.

In 1980, John Stine (Stine) became a tax principal at Arthur Young and took over the handling of the tax aspects of IMED. Stine had limited contact with Cramer and had no contact with Boynton. A note to the IMED tax file at Arthur Young that was written by Stine and dated January 16, 1981, stated that "some question exists that Section 83 applies" in situations where options were issued to employees of IMED. Notes that were recorded by Stine and dated February 5, 1981, indicated that petitioners had inquired whether the period of limitations on their treatment of the IMED options would run from the time of the section 83(b) elections. According to his notes, Stine determined that it would not. In a letter dated October 28, 1981, that was sent to Hendrickson and Monaghan, Stine stated that:

> IMED currently takes the position that its stock options are governed by Section 83 and therefore the

> present tax treatment is * * * no income to the employee on grant or exercise and no compensation deduction to IMED. However, Regulation 1.83-7 states that an option must have a "readily ascertainable fair market value" before Section 83 will apply. Since the definition of "readily ascertainable fair market value" is virtually impossible to meet, IMED's present position is subject to challenge. * * *

Stine suggested that IMED consider the new option rules relating to incentive stock options "in light of the potential exposure to exercising employees should the Internal Revenue Service be successful in asserting the nonapplication of Section 83". Monaghan discussed the Stine letter with Cramer.

In the latter part of 1981, the management of the Warner-Lambert Corp. (Warner-Lambert) approached the officers and directors of IMED to propose a transaction whereby Warner-Lambert would acquire all of the outstanding stock of IMED and International. On July 8, 1982, petitioners terminated the trust agreement. In August 1982, Warner-Lambert purchased all of the outstanding stock of IMED for approximately $163 per paired share of stock in IMED and International. Under the agreement between IMED and Warner-Lambert, the officers and directors of IMED, including Cramer, Boynton, and Monaghan, resigned as of the date of acquisition of IMED. As part of its negotiated offer to acquire all of the outstanding stock of IMED and International, Warner-Lambert agreed to purchase all of the outstanding vested and nonvested options to acquire the stock of IMED and International. Petitioners were paid approximately $163 less the option exercise price for each option to purchase shares of stock in IMED and International.

Cramer received $22,071,000 from the sale of the Cramer 1978 option, $684,006 from the sale of the Cramer 1979 option, and $3,190,500 from the sale of the Cramer 1981-100 options to Warner-Lambert. No consideration was paid to Cramer for his 1981-200 options. Boynton received $4,524,300 from the sale of the Boynton 1979 option and $3,190,500 from the sale of the Boynton 1981 option to Warner-Lambert. Monaghan received $678,645 from the sale of the Monaghan 1979 option and $1,595,250 from the sale of the Monaghan 1981 option to Warner-Lambert.

The 1982 income tax returns of the Cramers and the Monaghans, both dated August 9, 1983, were prepared under the direction of Robert W. Jassoy, Jr. (Jassoy), a California certified public accountant (C.P.A.) and attorney at the firm of Jassoy, Graff & Douglas. Jassoy was not provided with copies of the IMED options prior to preparing the 1982 tax returns for the Cramers and the Monaghans.

The Boyntons' 1982 tax return, dated April 11, 1983, was prepared under the direction of Charles Wieseler (Wieseler), a California C.P.A. Wieseler was not provided with any of the IMED options for review and, in fact, was unaware that Boynton had sold nonqualified stock options to Warner-Lambert.

The Cramers reported all but $1.3 million of their receipts from the options as long-term capital gain on their 1982 return. The sale of the Cramers' IMED options was set out on their 1982 return on a "Statement LD" titled "Stocks & Bonds", despite the inclusion of a second "Statement LD" titled "Options", and the options were misreported as having a basis of $7,535,620 and sales proceeds of $32,181,126. Cramer knew that he had no basis in the options.

Boynton and Susi M. Boynton (the Boyntons) and Monaghan and Dina E. Monaghan (the Monaghans) declared their receipts

on their respective 1982 returns as long-term capital gains. The sale of the Boyntons' IMED options was listed on their 1982 return on a Schedule D as "IMED Stock" with a zero basis. The sale of the Monaghans' IMED options was set out on their 1982 return on a form "Computer D", and the options were misreported as having bases of $58,500 and $2,500,000 and sales proceeds of $737,145 and $4,095,250, respectively. Monaghan knew that he had no basis in the options.

None of petitioners' 1982 returns disclosed that the IMED options were subject to any restrictive terms or risk of forfeiture; that section 83(b) elections had been filed with respect to certain of the IMED options; that the options were not traded on any established market; or that petitioners relied on the conference committee reports on the Tax Reform Act of 1976 (the 1976 Act), Pub. L. 94-455, 90 Stat. 1520, for their tax treatment of the receipts from the sale of the IMED options.

As a result of negotiations with IMED, and in order to be consistent with petitioners' treatment of the IMED options, Warner-Lambert did not claim tax deductions for compensation on its 1982 consolidated tax returns in relation to the payments made to petitioners for the IMED options. In doing so, Warner-Lambert relied exclusively on the representations of Monaghan and did not undertake its own investigation or analysis in order to verify the accuracy of such treatment.

After being informed that they were under audit by the IRS, the Cramers and the Monaghans filed amended tax returns for 1982 in July 1985, declaring a zero basis and corrected sales proceeds for the IMED options sold by them. The bottom-line gains reported on the amended returns were the same as on the original returns.

ULTIMATE FINDINGS OF FACT

As of the dates the IMED options were granted, they did not have readily ascertainable fair market values.

Petitioners knew that the IMED options did not have fair market values of zero at the time the filed section 83(b) elections reporting zero values for the options.

At the time they filed their 1982 returns, petitioners knew that their positions with respect to the proceeds from the sale of the IMED options were subject to challenge by the IRS.

Petitioners misrepresented the sale of the IMED options on their 1982 tax returns in a way that concealed the true nature of the transactions.

Petitioners did not rely on professional advisers and did not act in good faith in reporting the sale of the IMED options on their 1982 returns.

OPINION

Petitioners reported the amounts received from Warner-Lambert in exchange for the IMED options on their 1982 tax returns as long-term capital gains. Respondent determined that the income realized by petitioners from the sale of the IMED options is taxable as ordinary income in the year of its disposition because section 83 does not apply to the IMED options. Petitioners bear the burden of proving that respondent's determinations are erroneous. Rule 142(a).

Section 83 provides as follows:

> SEC. 83(a). GENERAL RULE. — If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of —

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property,

shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

(b) ELECTION TO INCLUDE IN GROSS INCOME IN YEAR OF TRANSFER. —

(1) IN GENERAL. — Any person who performs services in connection with which property is transferred to any person may elect to include in his gross income, for the taxable year in which such property is transferred, the excess of —

(A) the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over

(B) the amount (if any) paid for such property.

If such election is made, subsection (a) shall not apply with respect to the transfer of such property, and if such property is

subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.

* * * * * * * * * *

(e) APPLICABILITY OF SECTION. — *This section shall not apply to* —

* * * * * * * * * *

(3) *the transfer of an option without a readily ascertainable fair market value,* * * *

* * * * * * * * * * *

(h) DEDUCTION BY EMPLOYER. — In the case of a transfer of property to which this section applies * * *, there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such property was transferred, an amount equal to the amount included under subsection (a), (b), or (d)(2) in the gross income of the person who performed such services. Such deduction shall be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services.
[Emphasis added.]

Section 1.83-7, Income Tax Regs., sets forth rules for determining the tax treatment in the case of a taxpayer who receives a "nonqualified stock option"; i.e., options to which section 421 does not apply. Sec. 1-83-7(a), Income Tax Regs. The parties agree that the IMED options were nonqualified stock options. Section 1.83-7(a), Income Tax Regs., provides that, if section 83(a) does not apply to the grant of an option because it does not have a readily ascertainable fair market value at the time of grant, "the taxpayer realizes compensation income only when the option is exercised or otherwise disposed of in an arm's-length transaction." *Pagel, Inc. v. Com-*

missioner, 91 T.C. 200, 208 (1988), affd. 905 F.2d 1190 (8th Cir. 1990).

When an option is not actively traded, the regulations provide that it does not have a readily ascertainable fair market value unless the fair market value of the option can be otherwise measured with reasonable accuracy. To meet this standard, a taxpayer must show that all of the following conditions exist:

> (i) The option is transferable by the optionee;
>
> (ii) The option is exercisable immediately in full by the optionee;
>
> (iii) The option or the property subject to the option is not subject to any restriction or condition * * * which has a significant effect upon its fair market value; and
>
> (iv) The fair market value of the option privilege is readily ascertainable in accordance with * * * [sec. 1.83-7(b)(3), Income Tax Regs.].
>
> [Sec. 1.83-7(b)(2), Income Tax Regs.]

An option is not "transferable" unless it can be transferred to any person other than the transferor and is not subject to substantial risk of forfeiture. Sec. 1.83-3(d), Income Tax Regs. In determining whether the value of the option privilege is readily ascertainable, it is necessary to consider: (i) Whether the value of the property subject to the option can be ascertained; (ii) the probability of any ascertainable value of such property increasing or decreasing; and (iii) the length of the period during which the option can be exercised. Sec. 1.83-7(b)(3), Income Tax Regs.

Petitioners filed section 83(b) elections for the Cramer 1978 option and for the Boynton and Monaghan 1979 options but did not file elections for the Cramer 1979 option or for the 1981 options. In each case, in determining the proper tax treatment of the cash received upon disposition of the IMED options in 1982, the threshold issue is whether the options had readily ascertainable fair market values at the times of transfer. If not, section 83 does not apply to the options, and, under section 1.83-7(a), Income Tax Regs., the options are taxable on their disposition as compensation.

Petitioners assert three theories that the proceeds were properly reported as long-term capital gains: (1) The IMED options had readily ascertainable fair market values within the meaning of section 83(e)(3) and section 1.83-7(b)(2), Income Tax Regs; (2) petitioners irrevocably elected to value the options at the time of grant under section 83(b); or (3) section 1.83-7(b)(2), Income Tax Regs., is invalid insofar as it requires immediate exercisability in order for an option to have a readily ascertainable fair market value. Respondent argues that the options did not have "readily ascertainable" values, that section 83(b) elections are not dispositive as to the treatment of the sales proceeds for 1982, and that the regulations are valid.

The IMED options were not actively traded. Under the express provisions of the options, the Cramer 1978 option could not be exercised at all until 10 months after its grant date, the 1979 options could not be exercised at all until at least 4 months after their grant dates, and the 1981 options could not be exercised at all until almost 2 years after their grant dates. The 1978 and 1979 options also contained transfer restrictions, including transfer being subject to vesting provisions. The express vesting provisions and transfer restrictions prevent the IMED options from being transferable or "im-

mediately exercisable" as required by section 1.83-7(b)(2), Income Tax Regs. See *Pagel, Inc. v. Commissioner, supra* at 209.

Further, the testimony of petitioners and their experts shows that the value of the IMED options was in fact not readily ascertainable when they were granted. Petitioners, who owned and ran IMED, and Hendrickson, a C.P.A. familiar with IMED, reported a zero value at the time the options were granted. At trial, Cramer and Boynton, the founders and top executives at IMED, testified that they could not determine the value of the options at the time of grant. Monaghan claimed to believe that the op ions had readily ascertainable fair market values of zero when they were granted, because the option exercise prices were higher than the then prices of the underlying stock. Of course, this relationship between the exercise price and the price of the stock at the time of the grant is hardly unusual. See generally *Laureys v. Commissioner* 92 T.C. 101, 102-104 (1989). Monaghan also testified that the purpose for granting the options was compensatory, "as a reward". In view of the opinions of Cramer and Boynton that the options had value, and because it is implausible that Monaghan believed that something with no value would serve as a "reward" to employees, Monaghan's testimony that he believed the options to have a zero value at the time of grant is not persuasive.

Petitioners now claim that the options had readily ascertainable fair market values of greater than zero at the time of grant. Petitioners presented the expert testimony of Kenneth A. Bodenstein (Bodenstein) as to the values of the options at the time they were granted. Bodenstein had no specific knowledge of IMED, but he determined a range of possible values under a formula called the "Black-Scholes" model and then used the "Shelton" and "Kassouf" models to pick out the "correct values". The Black-Scholes model was designed

for publicly traded options. Thus, Bodenstein's valuation depended on estimates of the underlying stock value and the volatility of the underlying stock value. Bodenstein estimated that IMED's common stock was "in the range of $10.00-$11.00 per share at September 1, 1978, $20.00-22.00 per share at September 1, 1979, and was $47.50-$51.50 per share at June 1, 1981." Depending upon what values were used for the unknown factors, the models came up with the following range of values for the IMED options:

Option	*Range of values*
1978	$4.00 to $5.90
1979[1]	10.45 to 14.10
1981-100	15.50 to 24.45
1981-200	6.05 to 19.45

[1]This valuation applies only to the Boynton and Monagahan 1979 options.

Bodenstein determined that the Cramer 1978 option had a $4.50 per share value, the 1979 options had a $12-per-share value, the 1981-100 options had a $19-per-paired-share value, and the 1981-200 options had an $11-per-paired-share value on the respective dates of grant. Bodenstein then applied a 25-percent discount to the values for lack of marketability to determine the following values: $3.38 per share for the Cramer 1978 option, $9 per share for the Boynton and Monaghan 1979 options, $14.25 per paired share for the 1981-100 options, and $8.25 per paired share for the 1981-200 options. Bodenstein's valuations depended heavily on assumptions made with respect to unknown factors, to wit, the stock value, the discount for lack of marketability, and the volatility fo the underlying stock value, based on companies determined by Bodenstein to be comparable. In addition, these valuation methods did not take into account the vesting and transfer restrictions on the IMED options. If Bodenstein's stock valuations were

correct, petitioners' 1979 options would have had values at least equal to the difference between the stock value ($20 to $22 per share) and the option exercise price ($8 for Cramer and $13 for Boynton and Monaghan). Significantly, Cramer did not file an election with respect to the 1979 options. "Consistency" would have required Cramer to report ordinary income at that time.

Petitioners claim that, in valuing the options, we should overlook the express restrictions on the options because the restrictive provisions of the options were included only because the options were executed on standard forms. Through their testimony and the testimony of other board members, petitioners attempt to negate the effect of such provisions and to claim that the options could have been immediately exercised in full by them. These contentions are in direct conflict with the express provisions of the options, with the representations made to the department of corporations, and with the proxy statement that was sent to IMED shareholders. Petitioners claim that the board members would have voted to waive the restrictions on the options. However, the board members, in representing the interests of the shareholders of IMED, should only have waived such restrictions if it were in the best interest of the IMED shareholders. Further, both Monaghan and Cramer testified that paragraph 6 of the Cramer 1978 option was included specifically with respect to that option. Paragraph 6 provided that "The intent of the vesting provisions and restrictions on exercisability * * * is to provide an inducement to Cramer to remain as an employee of IMED for a period of five years and to not voluntarily resign within that period." Petitioners have not persuaded us that the restrictions are meaningless and would never have been enforced.

Petitioners argue, alternatively, that the vesting and transfer restrictions in the IMED options would have no effect on

their fair market value. Bodenstein testified that the restrictive terms of the options, to wit, on vesting, transfer, and employment requirements, would not affect a potential buyer's offering price for such options. However, Rutledge testified that, if he was aware of the restrictions, they would have affected his option, at least as to market value. Moreover, petitioners' other expert, Steven L. Wagner (Wagner), and respondent's expert, I. Jeff Litvak (Litvak), testified that such restrictions could affect the value of the options.

Wagner stated in his report that

> Valuation of non-publicly traded assets necessarily must address the degree of transferability inherent in a non-publicly traded asset. Whether the asset is a common stock, an option or a warrant, the appraiser selects a discount for lack of marketability based on the facts available as of the appraisal's valuation date.

Wagner concluded that, because "estimating the degree of transferability is a typical consideration in the valuation of assets", the requirement of transferability under section 1.83-(b)(2)(i), Income Tax Regs., does not affect "the ability of the appraiser to estimate the fair market value of the options. * * * it would appear possible to estimate the degree of transferability of the Options and reflect such, quantitatively, in their appraisal". Wagner also concluded that the options could be valued even if tied to a vesting schedule, because a valuation consultant could perform a probability analysis to estimate the likelihood of the optionee's surviving to that date (under normal conditions), and the likelihood that they would have sufficient funds to exercise.

The opinions of Wagner, Litvak, and Rutledge are consistent with common sense. It is implausible that an investor faced with the choice of a restricted or nonrestricted option would

pay the same for each. Cf. *Estate of Hall v. Commissioner*, 92 T.C. 312, 338-339 (1989) (expert's opinion that did not take transfer restrictions into account considered unreasonable or unreliable evidence of fair market value).

In these cases, that a valuation expert may be able to calculate a value for the options is not enough to satisfy the requirement that the value be "readily ascertainable". Bodenstein's models did not account for the effect of any restrictions on the option values. Even if an accurate value could be determined with consideration of transfer and vesting restrictions, petitioners created fatal uncertainties in their evidence of conflict between express provisions and probable effects of the restrictions and vesting schedules. Testimony of petitioners and their witnesses indicates a possibility that the vesting provisions and transfer restrictions might not be enforced. Thus, it would have been unclear to potential purchasers at the time the options were granted exactly what restrictions would apply to the options or even how many were outstanding at any particular time. Where the restrictions affecting value could not be ascertained, there could not have been a readily ascertainable fair market value, determined with reasonable accuracy, at the time the options were granted. By using the term "readily ascertainable" to modify "fair market value", Congress expressed an intent to exclude unreliable methods to value options, such as the IMED options, that were not publicly traded and contained substantial restrictions. Sec. 83(e)(3).

Petitioners argue that their section 83(b) elections were in accordance with congressional intent and warrant a finding that such options had readily ascertainable fair market values at the time they were granted. Though petitioners do not limit the scope of this argument, we presume it is applicable only to the options for which section 83(b) elections were made. Petitioners cite the conference committee report to the 1976 Act (the 1976 conference report), which stated:

> The conferees intend that in applying these [restricted options] rules in the future, the Service will make every reasonable effort to determine a fair market value for an option (i.e., in cases where similar property would be valued for estate tax purposes) where the employee irrevocably elects (by reporting the option as income on his tax return or in some other manner to be specified in regulations) to have the option valued at the time it is granted * * * . The conferees intend that the Service will promulgate regulations and rulings setting forth as specifically as possible the criteria which will be weighed in valuing an option which the employee elects to value at the time it is granted. [S. Conf. Rept. 94-1236 (1976), 1976-3 C.B. (Vol. 3) 807, 842-843.]

The 1976 conference report accompanied the 1976 legislation amending section 422 as applicable to qualified stock options granted to employees. Such legislation was subsequent to the enactment of section 83 and the release of the proposed section 83 regulations but prior to the promulgation in final form of section 1.83-7, Income Tax Regs. Petitioners assert that we should look to this "subsequent legislative history" to determine legislative intent for determining whether an option has a readily ascertainable fair market value. In the alternative, they argue that the section 83 regulations are contrary to the intent of Congress and should not be followed.

Although the taxpayers in *Pagel, Inc. v. Commissioner*, 91 T.C. 200 (1988), affd. 905 F.2d 1190 (8th Cir. 1990), did not make a section 83(b) elections, the Court's analysis there, regarding the interpretation of readily ascertainable fair market value, is applicable to the cases at hand:

Our role in the constitutional scheme * * * is not to draft the law; it is solely to interpret it. Indeed, we are constrained to uphold a regulation if it has a reasonable basis in the statutory history, even though a taxpayer's challenge to the policy behind the regulation has logical force. *National Muffler Dealers Association, Inc. v. United States*, 440 U.S. 472, 488 (1979); *Fulman v. United States*, 434 U.S. 528, 530 (1978). "Congress has delegated to the Commissioner, not to the courts, the task of prescribing all needful rules and regulations for the enforcement of the Internal Revenue Code. 26 U.S.C. section 7805(a)" *Bingler v. Johnson*, 394 U.S. 741, 750-751 (1969); *United States v. Correll*, 389 U.S. 299, 307 (1967). See also *National Muffler Dealers Association, Inc. v. Commissioner*, 440 U.S. at 488; *Weigl v. Commissioner*, 84 T.C. [1192] at 1214 [(1985)]. Treasury regulations are not to be rejected unless they are unreasonable and plainly inconsistent with the statute, and they should not be overruled except for weighty reasons. *Bingler v. Johnson*, 394 U.S. at 750; *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948); *Weigl v. Commissioner*, 84 T.C. at 1213-1214.

The Code states only that section 83 "shall not apply to * * * the transfer of an option without a readily ascertainable fair market value." Sec. 83(e)(3). The legislative histories that accompany the enactment of section 83 provide no elaboration whatsoever on that provision. See H. Rept. 91-413, 1969-3 C.B. 200, 255, 377; S. Rept. 91-552, 1969-3 C.B. 423, 501; H. Rept. 91-782 (Conf.), 1969-3 C.B. 644, 659-660. Part 2 of the House report, however, is a "Technical Explanation of the Bill." See 1969-3 C.B. at 340. The Technical Explanation's discussion

> of the provision which ultimately was enacted as section 83 includes at least two references to "existing regulations." 1969-3 C.B. at 376. Those references indicate, to us at least, that Congress likely was aware of the then-existing regulations with respect to the transfer of property in connection with the performance of services. Sections 1.61-15 and 1.421-6 were two such regulations.
>
> Congress did not specify any changes from the regulations' treatment of whether an option transferred in connection with the performance of services had a "readily ascertainable fair market value," when it had a clear opportunity to do so. Arguably, Congress' silence in that regard may amount to a legislative enactment of the regulation provisons regarding whether options have a readily ascertainable fair market value. See *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110, 115-116 (1939); 1 J. Mertens, Law of Federal Income Taxation, sec. 3.22 (1982 rev.). In any event, Congress has not enacted any statute that contradicts the provisions of regulation sections 1.61-15 and 1.421-6, or regulations section 1.83-7, in the 25 years since such provisions first were enacted. * * * [*Pagel, Inc. v. Commissioner*, 91 T.C. at 218-220; fn. ref. omitted.]

In considering the 1976 conference report, the Court in *Pagel, Inc.* stated the following:

> Commentators have suggested that Congress' statement in 1976 indicates disapproval with the regulation provisions specifying when the value of an option is "readily ascertainable." See, e.g., Billman, "nonstatutory Stock Options," 383 Tax Management A-8 (1984); Diamond & Salles, "The

> Receipt of Property for Services After the TRA," Tax Advisor 325, 334 (May 1988); Nolan, "Deferred Compensation and Employee Options Under the New Section 83 Regulations," 56 Taxes 790, 795-796 (1979). We, however, do not interpret that statement to express Congress' disapproval of the regulation provisions. As embodied in the regulations under sections 61 and 421 and the proposed regulations under section 83, the Treasury position has been consistent since 1961 on the issue of when an option has a readily ascertainable value. If Congress in 1976 truly disapproved of the Treasury position, it could have enacted statutory provisions and superseded the Treasury's ability to take such a position. [*Pagel, Inc. v. Commissioner*, 91 T.C. at 220.]

Petitioners argue that it is a crucial distinction that section 83(b) elections were not filed in the *Pagel, Inc.* case. We disagree. In both *Pagel, Inc.* and the instant cases, because the options did not have readily ascertainable fair market values when granted, section 83 does not apply to the options. Thus, the filing of section 83(b) elections is an irrelevant distinction.

Petitioners cite *Walt Disney Productions v. United States*, 480 F.2d 66 (9th Cir. 1973), for the proposition that the 1976 conference report, as subsequent legislative history, should be given much weight. No matter how much weight we give to the 1975 conference report, we do not interpret the language therein to mean that, if a section 83(b) election is made, an option must be treated as having a readily ascertainable fair market value. The language of section 83(e) refutes this contention. Because we find that the IMED options did not have a readily ascertainable fair market value, the report language does not help petitioners.

Petitioners further argue specifically that the "immediately exercisable" requirement of section 1.83-7(b)(2)(ii), Income Tax Regs., is invalid. Petitioners claim that excluding all options that are not immediately exercisable from the definition of "readily ascertainable fair market value" is unreasonable, inconsistent with, and an improper implementation of, congressional mandate.

Treasury regulations are not to be rejected unless they are unreasonable and plainly inconsistent with the revenue statutes. *Bingler v. Johnson*, 394 U.S. 741, 750-751 (1969). Our task has been defined as follows:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question of whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute. [*Chevron, U.S.A. v. Natural Res. Def. Council*, 467 U.S. 837, 842-843 (1984); fn. refs. omitted.]

Section 83 does not contain a definition of the term "readily ascertainable fair market value". Thus, we must determine whether the inclusion of a requirement of immediate exercis-

ability in the definition of "readily ascertainable fair market value" is a valid and permissible construction of the statute.

Petitioners argue that, although the lack of immediate exercisability may affect the value of the options, it is not so critical that its presence prevents an option from having an "ascertainable fair market value". The failure of the formulas used by Bodenstein to take immediate exercise restrictions into account supports the contention that an option with such a restriction is harder to value. See *Pagel, Inc. v. Commissioner, supra* at 207. Whether an option is "immediately exercisable" does affect the ability to value an option at grant. Thus, we cannot conclude that the regulation presents an impermissible construction of the statute that would cause it to be invalid.

Petitioners argue that the treatment of the options was consistent and that to change the character of the proceeds received in 1982 would result in a windfall for respondent. Petitioners claim that Warner-Lambert did not take any compensation deductions in 1982 upon disposition of the options. Petitioners admit, however, that Warner-Lambert agreed to forgo deductions as a result of the negotiations between petitioners and Warner-Lambert. Petitioners are not entitled to bootstrap a nonmeritorious position by negotiating with third parties to play along with it. Determination of petitioner's correct liability is in no way a "windfall" to the Government.

Try as they might to characterize the issues in these cases as involving complex questions of law, petitioners cannot overcome the facts that scuttle their untenable positions. Petitioners ask us to hold that they qualify for capital gain treatment under the regulations, but, to do so, we must disregard the express written terms of the options. Disregard of the written terms of the options only creates more uncertainty as to the valuation of the options. Petitioners argue that congressional intent is on their side, but they sought unwarranted

tax benefits, i.e., capital gain rates on the total amount of their compensation, by claiming zero fair market values, which they knew to be false, for their options for the years of grant. Further, petitioners claimed capital gain treatment for the Cramer 1979 option and the 1981 options for which no elections were made. Surely, Congress did not intend to allow taxpayers to include a fair market value of zero for compensatory property, regardless of whether the actual value could be determined, thereby to defer tax on income and ultimately to treat compensation as capital gains merely by filing an election containing baseless information. Section 83(e)(3) precludes option proceeds from receiving capital gain treatment if the option values were not readily ascertainable at the time of grant. Because the 1978 and 1979 options had no readily ascertainable fair market values, factually and legally under section 83 and the regulations thereunder, we hold that petitioners had ordinary income in 1982 from the sale of the IMED options.

1981 Trust

With respect to the 1981 options, petitioners claim that the interests in the trust that were transferred to petitioners constituted "property" under section 83 and were therefore taxable to petitioners as compensation upon receipt under section 83(a). Respondent asserts that petitioners used the trust to avoid reporting the compensation from the 1981 options as ordinary income. Respondent argues that the trust was a sham with no other purpose than the avoidance of income tax and should therefore be ignored.

When the form of a transaction had not, in fact, altered any cognizable economic relationships, the courts will look through the form and apply the tax law according to the substance of a transaction. *Zmuda v. Commissioner*, 79 T.C. 714, 719-720 (1982), affd. 731 F.2d 1417 (9th Cir. 1984).

The sole property of the trust was the 1981 options. The 1981 options were granted to the petitioners in consideration of their continued personal services. Although in a different form, the 1981 options contained provisions similar to those in the 1978 and 1979 options. The 1981 options did not vest for over 2 years after they were granted, contained vesting provisions over a number of years, and could be divested upon voluntary termination of employment by the optionee. Petitioners did not report the receipt of their interests in the trust in the year of transfer and declared no income upon the receipt of the interests in the trust as they had declared no income on the receipt of the 1978 and 1979 options. The trust was terminated before any vesting occurred and before the sale to Warner-Lambert. Upon the sale of IMED to Warner-Lambert, the 1981 options were treated the same as the 1978 and 1979 options and were sold for the same price.

While petitioners state in their brief that the trust had a legitimate, nontax business purpose, they do not state what that business purpose was. The only evidence in the record that indicates a nontax purpose for the trust is Cramer's testimony that the trust was set up to keep the directors' options separate from the options of the other employees and to enhance IMED's international business relationship with the trustee. There is no plausible explanation in the record as to why such options would need to be kept separately. Further, petitioners presented no evidence that IMED would benefit from a relationship with the trustee, and Cramer testified that the 1981 options were issued in anticipation of the probable sale of the company, in which case the benefit of building a relationship with an international trustee is even less clear. Petitioners have not met their burden of proving the validity of the trust. We therefore hold that the trust should be disregarded and, for the reasons set out with respect to the 1978 and 1979 options, that the proceeds from the sale of

the 1981 options received by petitioners constituted ordinary income to them in 1982.

Cramers' Exclusion of $1.3 Million of Proceeds

The Cramers excluded $1.3 million of the proceeds from the sale of Cramer's options to Warner-Lambert. Petitioners claim that, pursuant to an oral agreement, $1.3 million worth of the proceeds was held for certain IMED senior salespeople, who, petitioners claim, were the beneficial owners of those funds. At trial, Cramer could only remember that $400,000 was paid to one of the salespeople. Petitioners presented no other evidence of any agreement or that any payments were actually made. We cannot determine whether alleged agreement, if it existed, was a Cramer transaction or an IMED transaction. Petitioners have failed to prove that the Cramers are entitled to exclude the $1.3 million from their income for 1982 based only on Cramer's vague and incomplete testimony.

Section 6653(a) Additions to Tax

Respondent determined in the notices of deficiency that the section 6653(a) additions to tax applied on the entire underpayment as to each petitioner. Petitioners bear the burden of proving that such additions to tax to not apply. Rule 142(a); *Luman v. Commissioner*, 79 T.C. 846, 860-861 (1982).

Section 6653(a)(1) imposes an addition to tax equal to 5 percent of the underpayment of tax if any part of the underpayment is due to negligence or intentional disregard of the rules or regulations. Section 6653(a)(2) provides for a further addition to tax equal to 50 percent of the interest due on the portion of the underpayment attributable to negligence or intentional disregard of the rules or regulations. For purposes of section 6653(a), "Negligence is lack of due care or failure to do what a reasonable and ordinarily prudent person would do

under the circumstances." *Neely v. Commissioner*, 85 T.C. 934, 947 (1985) (quoting *Marcello v. Commissioner*, 380 F.2d 499, 506 (5th Cir. 1967)).

In limited situations, taxpayers can avoid the section 6653(a) additions to tax if they have furnished all of the relevant information to a tax preparer or other professional and relied on that person's professional advice as to the proper tax treatment. See *United States v. Boyle*, 469 U.S. 241, 251-252 (1985); *Jackson v. Commissioner*, 86 T.C. 492, 539-540 (1986), affd. 864 F.2d 1521 (10th Cir. 1989); *Daugherty v. Commissioner*, 78 T.C. 623, 641 (1982); Magill v. Commissioner, 70 T.C. 465, 479 (1978), affd. 651 F.2d 1233 (6th Cir. 1981); *Pessin v. Commissioner*, 59 T.C. 473, 489 (1972).

Petitioners claim that they were not negligent because their tax positions were reasonably debatable, even if incorrect, and that the imposition of an addition to tax is inappropriate where the taxpayer has made a good faith effort to comply with law that is complex, unclear, or unsettled. Petitioners claim that they are not subject to the section 6653(a) additions to tax because they relied on advisers, key employees, and accountants for the positions that they took in reporting long-term capital gains on the proceeds from the sale of the options.

We are not persuaded. To the contrary, we agree with respondent that petitioners intentionally disregarded applicable regulations. Their claims of good faith are undermined by the evidence of what they told or did not tell their advisers and what their advisers told them.

Neither Jassoy nor Wieseler nor any of the other tax preparers purportedly relied upon by petitioners were provided with the relevant IMED options. Before preparing the 1982 returns, Jassoy was advised that elections had been filed with respect to the options and that long-term capital gain treatment was appropriate under the advice of Arthur Young.

Moreover, Cramer admitted that Jassoy had told him that his 1982 tax return position was subject to challenge.

Petitioners claim that they relied on Hendrickson. Hendrickson testified that he advised petitioners that the proposed IMED option program was contrary to the section 83 regulations and cautioned them that overturning a regulation is very difficult.

Petitioners claim that Monaghan relied on Rutledge in the decision to file section 83(b) elections. Rutledge stated that he had never seen the IMED options, that he never considered the valuation of the options, and that neither IMED nor petitioners ever engaged him to render a formal opinion on behalf of Arthur Young. He further testified that whether the options were immediately exercisable or had substantial vesting requirements are factors that would have affected the opinion as to the options' fair market value and as to whether the options had a readily ascertainable fair market value when granted. Further, Monaghan cannot rely on Rutledge's advice for tax treatment in 1978 to negate additions to tax attributable to his 1982 return.

Petitioners claim that their advisers relied on *Alves v. Commissioner*, 79 T.C. 864 (1982), affd. 734 F.2d 478 (9th Cir. 1984), in determining the tax treatment of the IMED options. Petitioners cite Judge Whitaker's dissent in *Alves* for the proposition that the Court agreed that zero income could be reported at the time of the grant of an option and that capital gains could then be reported on its sale. *Alves* involves the issue of whether section 83 applied where the taxpayer paid fair market value for stock when he received it and thus received no income when the stock was transferred to him. The issues in *Alves* bear no relation to the cases at hand where petitioners attempted to report *a fair market value* of zero on receipt of their options and where the issue is whether the IMED options had readily ascertainable fair market values

when they were transferred. Further, the *Alves* case involved restricted stock that was issued to the taxpayer, not options. Section 83(e) explicitly excepts from the application of section 83 options without a readily ascertainable fair market value at the time of transfer. There is no such exception for restricted stock.

Petitioners claim to have exhaustively researched the section 83 issue, yet neither they nor the professionals they claimed to have relied upon kept any written notes or memoranda in support of the positions taken on their 1982 returns. Nor did petitioners ask any of their advisers to render a formal opinion on these matters. The only written records produced at trial, pursuant to a subpoena on Arthur Young, memorialized the doubts of the parties as to treating the income from the options as capital gains.

Both Cramer and Monaghan were unequivocally put on notice in 1981 by the Stine letter, which stated that, because "the definition of 'readily ascertainable fair market value' is virtually impossible to meet, IMED's present position [that section 83 governed IMED's stock options] is subject to challenge." The evidence shows that petitioners had serious doubts about the viability of their plan to obtain capital gain treatment upon the sale of the options but that they proceeded because they believed they had nothing to lose and had a large incentive to try.

Boynton testified that he relied on Hendrickson, Monaghan, and Cramer in taking the position on his 1982 return that the option proceeds were long-term capital gains. He also testified that no suggestion was made to him at any time that there was any risk at all in taking such position or that it was subject to challenge in any way. Hendrickson testified that he told all petitioners of the risks they were taking, and we have concluded that Cramer and Monaghan acted with knowledge in taking a position contrary to existing regulations. Cramer and Monaghan would have had to have actively

misled Boynton for him to have been unaware of the risk associated with his 1982 tax return position. Petitioners have not suggested and, in view of petitioners' friendship and business relationship, we do not believe, that this occurred. Further, Boynton's 1982 return did not even indicate that he sold his options.

Petitioners argue that they disclosed their positions through their section 83(b) elections and that the IRS was therefore on notice of their treatment of the options. They cite *Belz Investment Co. v. Commissioner*, 72 T.C. 1209, 1233 (1979), affd. 661 F.2d 76 (6th Cir. 1981); *Burbank Liquidating Corp. v. Commissioner*, 39 T.C. 999, 1011 (1963), affd. in part, revd. in part on other grounds, and remanded 335 F.2d 125 (9th Cir. 1964); and *Wesley Heat Treating Co. v. Commissioner*, 30 T.C. 10, 26 (1958), affd. 267 F.2d 853 (7th Cir. 1959), for the proposition that disclosure indicates good faith and makes the negligence addition to tax inapplicable. All of the cited cases involve disclosure on or with the income tax return for the year of the underpayment. There was no disclosure on or with petitioners' 1982 returns. Moreover, petitioners claim to rely on elections filed several years before the year in issue, while on the 1982 returns the sale of the options was misrepresented and in effect concealed. Finally, petitioners reported sales proceeds from IMED options for which section 83(b) elections were made together with proceeds from IMED options for which no election was made.

Petitioners further point to their "consistent" treatment of the options as proof of their good faith. We regard their alleged consistency as further evidence of an ongoing scheme.

Petitioners argue that they are not subject to additions to tax because they disregarded the regulations in reliance on the 1976 conference report and professional articles and believed that the section 83 regulations were contrary to congressional intent. Petitioners were aware that their tax return positions

were contrary to the regulations as they then existed and did not have any reasonable basis for valuing the options at zero on the elections they filed. We conclude that petitioners did not act in good faith but deliberately claimed an untenable position and concealed it on their 1982 returns. Accordingly, petitioners are subject to the additions to tax under section 6653(a). See *Grant v. Commissioner*, 84 T.C. 809, 827 (1985), affd. without published opinion 800 F.2d 260 (4th Cir. 1986).

Substantial Understatement Addition to Tax

Section 6661(a) provides for an addition to tax on underpayments attributable to a substantial understatement of income tax. An understatement is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. Sec. 6661(b)(1)(A). Petitioners had substantial understatements in each of the years at issue. The section 6661 addition to tax is not applicable, however, if there was substantial authority for the taxpayer's treatment of the items in issue or if the relevant facts relating to the tax treatment were adequately disclosed on the return. Sec. 6661(b)(2)(B)(i) and (ii).

Petitioners argue that there was substantial authority for the treatment of their returns of the IMED option sales proceeds. There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of the authorities supporting contrary positions. *Accardo v. Commissioner*, 942 F.2d 444, 453 (7th Cir. 1991), affg. 94 T.C. 96 (1990); sec. 1.6661-3(b), Income Tax Regs. As evidence that the 1976 conference report should be treated as "authoritative", petitioners point to proposed regulations under sections 1.83-6 and 1.83-7, Income Tax Regs. These proposed regulations provided that options not actively traded

on an established market would be presumed not to have a readily ascertainable fair market value at the time of grant, unless certain reporting requirements were satisfied. Petitioners did not satisfy such reporting requirements. Further, the proposed regulations did not indicate that satisfaction of the reporting requirements would guarantee a finding of readily ascertainable fair market value. Finally, these proposed regulations were withdrawn on June 27, 1983, before Cramer and Monaghan filed their 1982 returns. 48 Fed. Reg. 29538 (June 27, 1983). The language in the 1976 conference report is greatly outweighed by the language of the statute, section 83(e), and the regulations in effect at the time the returns were filed. Moreover, as we have previously concluded, the authorities relied on by petitioners do not support the positions taken on their returns.

Petitioners claim that they disclosed their positions for purposes of section 6661 by filing section 83(b) elections in 1978 and 1979. In order to claim adequate disclosure on a return, the disclosure must have been arranged in a manner that "reasonably may be expected to apprise the Internal Revenue Service of the identity of the item, its amount, and the nature of the potential controversy". Sec. 1.6661-4(b)(3), Income Tax Regs. Section 83(b) elections were not filed for all of the options, and for none of the options were copies of the elections filed with the 1982 returns. There was no indication on the returns that elections were filed or that the options were restricted, and, as discussed earlier, each return contained misrepresentations that actually concealed the true nature of the option proceeds. In sum, there was not adequate disclosure on the returns regarding these underpayments.

Petitioners contend that the Commissioner should have granted them a waiver of section 6661 addition to tax. Section 6661(c) authorizes the Commissioner to waive any part of the addition to tax imposed under section 6661 on a showing

that (1) there was reasonable cause for the understatement and (2) the taxpayer acted in good faith. The denial of a waiver under section 6661(c) is reviewable by the Court on an abuse-of-discretion basis. *Mailman v. Commissioner*, 91 T.C. 1079, 1083 (1988).

The most important factor in determining reasonable cause and good faith under section 6661(c) is "the extent of the taxpayer's effort to assess [his] proper tax liability under the law." *Id.* at 1084; sec. 1.6661-6(b), Income Tax Regs. Reliance on the advice of an attorney or accountant constitutes a showing of reasonable cause and good faith under section 6661(c) only if, "under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith." Sec. 1.6661-6(b), Income Tax Regs. The record shows that, after repeated indications that their tax position would be contrary to existing regulations, petitioners did not choose to provide the options and other relevant information to a professional to obtain a reasoned opinion but chose instead to take their chances that the IRS would not challenge their returns. This conduct is not consistent with good faith.

In any event, petitioners' showing of reasonable cause and good faith would serve only to bring them to the point where respondent "*may* waive all or any part of the addition to tax". Sec. 6661(c) (emphasis added). Thus, petitioners must show that the reasonable cause and good faith are so clear that respondent's refusal is arbitrary, capricious, or without sound basis in fact. *Mailman v. Commissioner, supra* at 1084. In these cases, petitioners attempted to obtain long-term capital gain treatment instead of ordinary income treatment to obtain significant tax savings and did not include on their returns sufficient information to put the IRS on notice of the controversial nature of their position. Under these circumstances, we cannot say that respondent abused her discretion in denying

a waiver. Accordingly, we conclude that petitioners are subject to the additions to tax under section 6661.

Simultaneous Application of Sections 6653(a) and 6661

Petitioners argue that they cannot be liable for simultaneous additions to tax under both sections 6653(a) and 6661. They contend that the plain meaning of the statute here leads to an unreasonable result that is plainly at variance with the policy of the legislation as a whole, and, thus, under *Ozawa v. United States*, 260 U.S. 178, 194 (1922), we must examine the matter further. Petitioners contend that the legislative history of section 6661 indicates that Congress did not intend for an understatement of income tax to be simultaneously subject to the section 6653(a) addition to tax and the section 6661 addition to tax for a substantial understatement.

Section 6661 contains no provisions precluding the simultaneous assessment of these two additions to tax. The Supreme Court has explained the court's function in interpreting statutory language as follows:

> In the interpretation of statutes, the function of the courts is easily stated. It is to construe the language so as to give effect to the intent of Congress. * * *
>
> There is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes. Often these words are sufficient in and of themselves to determine the purpose of the legislation. In such cases we have followed their plain meaning. When that meaning has led to absurd or futile results, however, this Court has looked beyond the words to the purpose of the act. Frequently, however, even when the plain meaning did not produce absurd results but merely an unreasonable one

> "plainly at variance with the policy of the legislation as a whole" this Court has followed that purpose, rather than the literal words. * * *
>
> [*United States v. American Trucking Associations, Inc.*, 310 U.S. 534, 542-543 (1940); fn. refs. omitted.]

In statutes levying taxes, the literal meaning of the words is most important for interpreting such statutes and is not to be extended by implication beyond the clear import of the language used. *Crooks v. Harrelson,* 282 U.S. 55, 61 (1930); *United States v. Merriam;* 263 U.S. 179, 187-188 (1923); *Masonite Corp. v. Fly,* 194 F.2d 257, 260-261 (5th Cir. 1952). Further, "where a statute is clear on its face, we would require unequivocal evidence of legislative purpose before construing the statute so as to override the plain meaning of the words used therein." *Huntsberry v. Commissioner,* 83 T.C. 742, 747-748 (1984); see *Schwartz v. Commissioner,* T.C. Memo. 1992-677.

Petitioners admit that "literally Section 6661 does not prevent application of both Section 6653(a) and Section 6661 to the same deficiency". Petitioners claim that Congress failed to coordinate the two additions to tax because it did not contemplate the application of section 6661 in situations where section 6653(a) applied and it was therefore unnecessary to coordinate the sections. Because sections 6653(a) and 6661 both apply in such obviously overlapping circumstances, we are unpersuaded by this argument.

Section 6661 was enacted by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, sec. 323, 96 Stat. 324, 613. The committee report states:

> Taxpayers rely on opinions of tax advisors to avoid the possibility of fraud or negligence penalties in taking these highly questionable positions, even though

> the advisor's opinion may clearly indicate that if the issue is challenged by the Internal Revenue Service, the taxpayer will probably lose the contest. * * * The committee believes, therefore, that taxpayers should be subject to a penalty designed to deter the use of undisclosed questionable reporting positions. * * * [S. Rept. 97-494, at 273 (1982).]

Petitioners contend that the section 6661 addition to tax remedied the problems discussed in the committee reports by requiring a "substantial authority" standard that is harder to meet than the standard for the section 6653(a) addition to tax and that the section 6661 addition to tax was intended to apply where section 6653(a) did not. The committee reports accompanying TEFRA, however, do not explicitly state that the additions to tax under sections 6653(a) and 6661 cannot be simultaneously imposed on the same understatement of income tax. S. Rept. 97-494, at 273 (1982); H. Conf. Rept. 97-760 at 574 (1982), 1982-2 C.B. 600, 649. Thus, the legislative history does not contain unequivocal evidence to enable us to disregard the plain meaning of the statute. See *Schwartz v. Commissioner, supra.*

Section 6661 was repealed in 1989 by Omnibus Budget Reconciliation Act of 1989 (OBRA), Pub. L. 101-239, sec. 7721(c)(2), 103 Stat. 2106, 2399. OBRA eliminated the stacking of the accuracy-related additions to tax. H. Conf. Rept. 101-386, at 652 (1989). Petitioners contend that the elimination by Congress of the potential of overlap among the accuracy-related additions to tax is instructive in determining Congress' intent in the earlier passage of section 6661. The House report accompanying OBRA does not indicate, however, that Congress coordinated these additions to tax for the purposes of correcting an error in the interpretation and application of present law. Rather, it indicates that the purpose was to allay "confusion among taxpayers and * * * diffi-

culties in administering these penalties by the IRS'' caused by the number of different ''penalties'' relating to the accuracy of a tax return and to ''significantly improve the fairness, comprehensibility and administrability of these penalties.'' H. Rept. 101-247, at 1388 (1989). The legislative history repealing section 6661 does not indicate that Congress never intended the simultaneous assessment of the sections 6653(a) and 6661 additions to tax upon the same understatement of income tax. See *Schwartz v. Commissioner, supra.*

In addition, section 6661 does provide that it cannot be imposed on a substantial understatement on which a section 6659 addition to tax is imposed. Sec. 6661(b)(3). Thus, Congress was aware of potential overlap. The statute does not expressly address the simultaneous assessment of any other additions to tax together with those under section 6661. This is evidence that Congress did not intend to preclude the simultaneous assessment of additions to tax under sections 6653(a) and 6661. See *Estate of McClanahan v. Commissioner,* 95 T.C. 98, 106 (1990); *Schwartz v. Commissioner, supra.*

Given that section 6661 is clear on its face, and having found no unequivocal evidence of contrary congressional intent, we apply the plain meaning of section 6661. *Huntsberry v. Commissioner,* 83 T.C. 742, 747-748 (1984). Accordingly we hold that petitioners are liable for the additions to tax under both section 6653(a) and section 6661.

We have considered the other arguments of the parties with respect to both the character of the 1982 income and the additions to tax, and they are either without merit or not necessary in view of our resolution of the issues.

To reflect respondent's concession with respect to the computation of the section 6653(a) addition to tax with respect to the Cramers,

Decision will be entered under Rule 155 in docket No. 27682-90.

Decisions will be entered for respondent in docket Nos. 27684-90 and 29100-90.